Supreme Court of the United States

[illegible]

[illegible]

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG, PETITIONER,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR CERTIORARI FILED FEBRUARY [illegible], 194[illegible].

CERTIORARI GRANTED APRIL [illegible], 194[illegible].

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No.

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG, PETITIONER,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

INDEX.

[fol. 1]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 105828

Virginian Hotel Corporation of Lynchburg, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Appearances:

For Taxpayer: O. H. Tufts, C. P. A.

For Comm'r: E. L. Corbin, Esq.

Docket Entries

1940

Dec. 10. Petition received and filed. Taxpayer notified. (Fee paid).

Dec. 10. Copy of petition served on General Counsel.

1941

Jan. 30. Answer filed by General Counsel.

Jan. 30. Request for hearing in Washington, D. C., filed by General Counsel.

Feb. 3. Notice issued placing proceeding on Washington, D. C., Calendar. Answer and request served.

Sept. 18. Hearing set Nov. 10, 1941, Washington.

Nov. 10. Hearing had before Mr. Arnold on the merits. Submitted. Stipulation of facts (2) filed at hearing. Briefs due 1/10/42. Reply briefs due Jan. 24, 1942.

Nov. 24. Transcript of hearing Nov. 10, 1941, filed.

1942

Jan. 8. Brief filed by taxpayer.

Jan. 9. Motion for extension to Feb. 9, 1942 to file brief filed by General Counsel. 1/10/42 granted.

Feb. 9. Motion for extension to Mar. 11, 1942, to file brief filed by General Counsel. 2/10/42 granted.

Mar. 11. Motion for extension to March 30, 1942, to file brief filed by General Counsel. 3/12/42 granted.

Mar. 28. Brief filed by General Counsel. Served, 3/30/42.

Mar. 30. Copy of brief served on General Counsel.

Apr. 10. Reply brief filed by taxpayer. 4/11/42 copy served on General Counsel.

May 6. Memorandum opinion rendered, Arnold, Div. 12. Decision will be entered under Rule 50. 5/7/42 copy served.

May 13. Notice of settlement filed by taxpayer.

May 21. Hearing set June 10, 1942 on settlement.

May 21. Copy of notice of settlement and notice of hearing served on General Counsel.

May 25. Computation as to deficiency filed by General Counsel.

[fol. 2] May 28. Decision entered, Arnold. Div. 12.

Aug. 18. Petition for review by United States Circuit Court of Appeals, 4th Circuit, filed by General Counsel.

Aug. 25. Proof of service filed.

Aug. 26. Proof of service filed by General Counsel.

Sept. 9. Statement of points filed by General Counsel.

Sept. 9. Designation of portions of record filed by General Counsel.

Sept. 15. Proof of service of designation of record and statement of points filed by General Counsel.

[fol. 3] Before United States Board of Tax Appeals

Docket No. 105828

Virginian Hotel Corporation of Lynchburg, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Petition—Filed December 10, 1940

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency issued by the Internal Revenue Agent in Charge at Richmond, Virginia, and dated September 11, 1940; and as the basis of its proceeding alleges as follows:

1. The petitioner is a corporation chartered and existing under and by virtue of the laws of the Commonwealth of Virginia, with its principal office at Church and Eighth Streets, Lynchburg, Virginia.

The return for the period here involved was filed with the Collector of Internal Revenue for the District of Virginia at Richmond, Virginia.

2. The notice of deficiency (a copy of which is hereto attached, marked Exhibit A) was mailed to the petitioner on September 11, 1940.

The said notice of deficiency refers to Internal Revenue Agent's report mailed to the petitioner of February 2, 1940; therefore, a copy of said Revenue Agent's report is hereto attached, marked Exhibit B.

3. The tax in controversy is income and excess profits tax for the calendar year ended December 31, 1938, and in the amount of $555.26.

4. The determination of the tax set forth in said notice of deficiency is based upon the following errors:

(a). In determining the useful life of petitioner's depreciable assets to be:

Furniture and fixtures	20 Years
Carpets	12½ Years
Cafe Improvements	20 Years
Laundry Equipment	20 Years
Ice Machine	20 Years

[fol. 4] (b). In not determining that the depreciation, computed by the petitioner and deducted on its income tax returns for the years 1931 to 1935 inclusive in excess of the allowable depreciation computed according to the respondent's rates, should be restored to the undepreciated balance of the respective assets, the said excess depreciation for the years 1931 to 1935 inclusive, aggregating $28,262.78, not having been used to reduce taxable income on account of net losses; and in not determining that the corrected allowed depreciation for the year 1936, in excess of the corrected claimed depreciation, should be restored to the undepreciated balance of the assets, the said excess depreciation for the year 1936 in the amount of $3,137.47 not having been used to reduce taxable income on account of the corrected net loss for said year.

(c). In determining petitioner's total allowable depreciation for the year 1938 to be $1,295.47 instead of $4,341.97 as determined and claimed as a deduction by the petitioner.

(d). In not determining that the petitioner had made a reasonably accurate determination of the useful life of its respective assets and that the resultant depreciation for the year 1938 was an allowable deduction from gross income.

(e). In not determining that $70.00 capital stock tax paid for the year ended June 30, 1938, in excess of the amount of the said tax accruable at December 31, 1937, was a proper deduction from gross income for the calendar year 1938.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a). The petitioner operates the Virginian Hotel in Lynchburg, Virginia, as lessee. It owns the furniture and equipment in said hotel but does not have any interest in the hotel property and permanent fixtures.

This hotel was operated by other lessees until June 1, 1927, at which time A. F. Young and his wife, Mrs. R. E. Young, took over the unexpired lease. The Youngs operated as a partnership until December 31, 1931, when the partnership was incorporated as the petitioner herein, and all of the issued capital stock was given to the Youngs, with the exception of qualifying shares, for the net book value or cost of the assets to the partnership; the said stock having been issued in the ratio of their respective interests in the partnership.

(b). When the Youngs took over the unexpired lease of the hotel on June 1, 1927, it was completely furnished and equipped, the furniture and fixtures therein being the property of the prior lessee.

In order to avoid any interruption in the operation of the hotel, the Youngs purchased from the prior lessee all of the furniture and equipment therein for a lump sum of $70,899.94, which amount was allocated to the respective assets in the ratio of the undepreciated balance of the same items on the vendor's ledger.

[fol. 5] (c). The total amount expended for the original purchase of the furniture and equipment of the hotel and subsequent renewals to December 31, 1938, are as follows:

	Furniture and Fixtures	Carpets	Cafe Improvements	Laundry Equipment	Ice Machine	Total
Purchased from prior Lessee June 1, 1927	$38,400.20	$19,341.70	$7,232.40	$4,103.21	$1,822.43	$70,899.94
Additions 1927	$1,730.33	$1,247.90	$9,599.67	$........	$........	$12,584.90
1928	3,087.23	2,745.58	3,894.13	175.00	121.51	10,023.45
1929	692.35	2,395.99	659.08	....	325.00	4,072.42
1930	1,789.54	....	214.81	....	....	1,997.35
1931	15,033.55	4,406.74	3,057.04	1,011.23	241.65	23,750.21
1932	2,733.92	....	242.05	2,447.35	33.68	5,457.00
1933	....	....	....	....	102.96	102.96
1934	999.63	....	49.86	....	....	1,049.49
1935	184.57	814.36	....	....	....	998.93
1936	134.76	686.73	100.00	....	75.00	996.49
1937	544.85	622.54	....	....	....	1,167.39
1938	3,075.76	2,437.79	915.97	....	268.44	6,697.96
Total Additions	$30,006.49	$15,357.63	$18,732.61	$3,633.58	$1,168.24	$68,898.55
Grand Totals	$68,406.69	$34,699.33	$25,965.01	$7,736.79	$2,990.67	$139,798.49

(d). It was determined that the average useful life of the respective items of furniture and equipment would be:

Furniture and Fixtures	10 Years
Carpets	6⅔ Years
Cafe Improvements	10 Years
Laundry Equipment	10 Years
Ice Machine	10 Years

and depreciation has been charged off each year on this basis, allowance having been made for any items which became fully depreciated.

(e). The total depreciation charged off and claimed as a deduction from gross income for the year 1938 was $4,341.97.

(f). In 1940, the respondent determined that the average useful life of the respective items from the time of acquisition was:

Furniture and Fixtures	20 Years
Carpets	12½ Years
[fol. 6] Cafe Equipment	20 Years
Laundry Equipment	20 Years
Ice Machine	20 Years
Air Conditioning Equipment (a new item in 1938)	20 Years

and computed the allowable depreciation for the year 1938, as set forth in detail on pages 6 and 7 of Exhibit B, to be $1,295.47.

(g). The respondent having determined that the 20 and 12½ year useful life of the respective items was applicable from the time of their acquisition, depreciation for the prior years should be re-computed as set forth in detail in Exhibit C, annexed hereto and made a part of this petition.

(h). The difference between the depreciation computed according to the petitioner's rates for the years 1931 to 1935 inclusive, and the depreciation allowable according to the respondent's rates for the said period, was not used to reduce taxable income; therefore, this excess in the sum of $28, 262. 78 should be restored to the undepreciated cost of the assets at December 31, 1937. Excess deprecia-

tion in the amount of $3,137.47, deducted for the year 1936, should also be restored to the undepreciated balance of the assets at December 31, 1937. This amount is computed as follows:

		Deprec. Deducted Return	Net Loss Return
Original		$10,982.50	$1,663.95
Add: Depreciation allowable on carpets	$2,398.08		
" deducted	924.56		
Additional allowable resulting from decrease of allowable for 1931–1935		1,473.52	1,473.52
Corrected		$12,456.02	$3,137.47
Corrected income return loss		3,137.47	
Total depreciation allowed		$9,318.55	
Less: Minimum allowable:			
Carpets	$2,398.08		
Truck	37.50	2,435.58	
Balance depreciation allowed (1)		$6,882.97	

(1) Applicable to Fruniture and Fixtures, Improvements to Cafe, Laundry Machinery and Ice Machine, or 68.6892% of $10,020.44 deducted for these items.

[fol. 7] (i). The petitioner accr-ed at December 31, 1937, and deducted from gross income on its income tax return for the calendar year 1937, a capital stock tax of $55.00, payable July, 1938, computed according to the provisions of Section 105 of the Revenue Act of 1935 as amended by Section 401 of the Revenue Act of 1936, as follows:

Adjusted Declared Value, June 30, 1937—Form 707	$48,336.05
Additions:	
Net Income for Year 1937	7,235.91
	$55,571.96
Deductions:	None
Adjusted Declared Value, June 30, 1938	$55,571.96
Tax at $1.00 for each $1,000.00	$ 55.00

(j). Section 601 (f)(1) of the Revenue Act of 1938, effective May 28, 1938, gave taxpayers the right to declare a new value for the Capital Stock Tax year ended June 30, 1938, instead of using the adjusted declared value as required by the Revenue Act of 1935 as amended. Ac-

cordingly, the petitioner declared a value of $125,000.00 and paid a tax of $125.00, or $70.00 more than the amount accruable at December 31, 1937. The right to accrue and deduct the additional $70.00 Capital-Stock Tax did not exist prior to the enactment of the Revenue Act of 1938, or May 28, 1938.

6. Wherefore, the petitioner prays that this Board may hear the proceeding and determine:

(a). That the petitioner has correctly determined the average life of its depreciable assets and that the aggregate depreciation claimed as a deduction on its income return for the year 1938, in the amount of $4,341.97, is allowable.

(b). That if the Board determines that the average useful life of the respective assets, as determined by the respondent, should have been used, then, in that event, the allowable depreciation for the years 1931 to 1936 should be recomputed, using respondent's rates, and the excess depreciation deducted by the petitioner, aggregating $31,-400.25, should be restored to the undepreciated balance of the assets at December 31, 1937; and that the allowable depreciation for the year 1938 is $4,438.14, as set forth in detail in Exhibit B, annexed hereto and made a part of this petition.

(c). That the $70.00 Capital-Stock Tax paid for the year ended June 30, 1938, over and above the amount accrued and deducted by the petitioner at December 31, 1937, was not accruable prior to the effective date of the Revenue Act of 1938, or May 28, 1938, and that said $70.00 is a proper deduction from gross income for the year 1938.

O. H. Tufts, Agent for Petitioner, 512 Krise Building, Lynchburg, Virginia.

[fol. 8] *Duly sworn to by A. F. Young jurat omitted in printing.*

[fol. 9] EXHIBIT "A" TO PETITION

Treasury Department

Internal Revenue Service

Richmond, Virginia,
Sept. 11, 1940.

Virginian Hotel Corporation of Lynchburg, Church & 8th Streets, Lynchburg, Virginia.

GENTLEMEN:

You are advised that the determination of your income tax liability for the taxable year(s) ended Dec. 31, 1938 discloses a deficiency of $416.94 and that the determination of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $138.32 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Richmond, Virginia for the attention of IT:Rec. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by S. R. Brame, Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver.

ES.

[fol. 10] Statement

Virginian Hotel Corporation of Lynchburg,
Church and 8th Streets,
Lynchburg, Virginia

Tax liability for taxable year ended December 31, 1938.

Income Tax

Liability	Assessed	Deficiency
$1,978.39	$1,561.45	$416.94

Excess-Profits Tax

$138.32	$0.00	$138.32

In making this determination of your income tax and excess-profits tax liability, careful consideration has been given to the internal revenue agent's report dated January 31, 1940, copy of which was mailed to you February 2, 1940; to your protest dated April 30, 1940; to statements made at conference held in office of Internal Revenue Agent in Charge at Richmond, Virginia, on June 4, 1940; to letter from your accountant dated July 22, 1940 and to statements made at conference held before Technical Staff, Atlantic Division at Richmond, Virginia, on July 17, 1940.

A copy of this leeter and statement has been mailed to your representative, Mr. O. H. Tufts, C. P. A., Lynchburg, Virginia, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

Adjustments to Net Income—1938

Net income as disclosed by return	$11,688.90
Unallowable deductions and additional income:	
(a) Depreciation	3,046.50
(b) Capital stock tax	70.00
Net income adjusted	$14,805.40

[fol. 11] Explanation of Adjustments

(a) Your contention that the accumulated depreciation reserve at December 31, 1937, should not include the excess depreciation of prior years which did not reduce taxable income is denied.

Computation of excessive depreciation disallowed is as follows:

Rate	Assets	Cost	Depreciation Reserve 12/31/37	Depreciation 1938
5%	Furniture & Fixtures	$68,406.69	$56,722.75	$690.47
8%	Carpets	34,699.33	30,534.33	263.14
5%	Air Conditioning Equip	2,612.67	....	65.34
5%	Cafe Equipment	25,966.61	23,407.03	147.67
15%	Laundry Equipment	7,736.79	6,273.80	102.91
5%	Ice Plant	2,990.67	2,447.32	25.94
		142,412.76	119,385.23	1,295.47
	Depreciation claimed			4,341.97
	Excessive depreciation			3,046.50

(b) Your contention that additional capital stock tax for the year ended June 30, 1938 which accrued 7/1/37 but was paid in 1938 should be allowed as a deduction in that year is not allowed.

Computation of Tax

Excess-Profits Tax Computation

Value of capital stock as declared in the capital stock tax return for year ended 6/30/38	$125,000.00
Net income for excess-profits tax computation	14,805.40
Less: Dividends received credit	....
Balance of net income	14,805.40
Less: 10% of capital stock declared value	12,500.00
Net income subject to excess-profits tax	2,305.40
Amount taxable at 6%	2,305.40
Excess-profits tax at 6%	138.32
Total excess-profits tax	138.32
Tax previously assessed, original, account #410528	0.00
Additional tax to be assessed	138.32

Income Tax Computation

Net income for excess-profits computation	14,805.40
Less: Excess-profits tax	138.32
Net income	14,667.08
Special class net income	14,667.08
Portion taxable at 12½%—$5,000.00	625.00
Portion taxable at 14% 9,667.08	1,353.39
Total	1,978.39
Tax previously assessed, original, account #410528	1,561.45
Additional tax to be assessed	416.94

[fol. 12] EXHIBIT "B" TO PETITION

Treasury Department

Internal Revenue Service

Office of Internal Revenue Agent in Charge

Virginia Division

Richmond, Virginia,
February 2, 1940.

Virginian Hotel Corp. of Lynchburg, Church and Eighth Street, Lynchburg, Virginia.

GENTLEMEN:

I enclose a copy of the report of the examination of your income-tax returns for the years shown below. After consideration by this office, the following adjustment of your tax liability appears to be warranted, for the reasons stated in the report:

	Additional Tax	
Year	Income Tax	Excess Profits Tax
1938	$416.10	$144.32
Total Additional Tax:	$560.42	

If you agree to this adjustment, the enclosed form of waiver should be executed and forwarded to this office promptly, in order to permit the early assessment of the additional tax and to stop the accumulation of interest. Such interest will cease 30 days after the receipt of the executed form, or upon the payment of the additional tax to the collector, whichever occurs first.

If you desire to make immediate payment of the additional tax without awaiting assessment, you should forward your remittance to the Collector of Internal Revenue at *Richmond, Virginia,* enclosing this letter, or a copy thereof. Interest on the additional tax should be included in your remittance, computed at the rate of 6 percent per annum from the due date of the first installment to the date of payment.

If you do not agree to the proposed adjustment, you may file a protest, executed in triplicate under oath, with this office, within 30 days from the date of this letter, stating the grounds for your exceptions. Any protest so filed will have careful consideration, and, if you so request, an opportunity for a hearing in this office will be granted you prior ti final determination of any deficiency against you. This letter is not a final notice of deficiency, and this office will be pleased to answer any questions which may occur to you in your examination of the enclosed copy of the report.

Should you fail to pay the additional tax to the collector of internal revenue or to file with this office within the 30-day period mentioned either a waiver on the enclosed form or a written protest, final determination of your tax liability will be made and a notice of deficiency will be sent you in accordance with the provisions of law applicable to the assessment and collection of income- and excess-profits-tax deficiencies.

Your prompt acknowledgment of the receipt of this letter and related papers upon the enclosed form will be much appreciated.

(Signed) S. R. Brame, Internal Revenue Agent in Charge.

Enclosures: Report of examination. Form of waiver. Form of acknowledgment. Form 744.

MWM/iog.

[fol. 13] Virginian Hotel Corporation of Lynchburg

Table of Contents:

Preliminary Statement

Year	Deficiency in Excess Profits Tax	Deficiency in Income Tax
1938	$144.32	$416.10

Gross income and deductions from gross income were verified.

Depreciation

This hotel was opened in 1913. The present operators purchased the equipment as of June 1, 1917. A review of the ledger accounts discloses that expenditures for replacements, have been relatively small in amounts and that the greater part of the additions to the equipment accounts, were for betterments and additional equipment. A large addition to the hotel building was made in 1931. It is apparent that the rate of 10% is excessive and that the equipment has an average life of approximately twenty years.

Mr. A. F. Young and wife operated this hotel as a partnership from June 1, 1927 to 1930. It was incorporated in 1930 and has since been operated as a corporation. Values of the assets remained unchanged after the incorporation since no change in actual ownership was involved.

The deficit of $56,020.25 was created by large operating losses during the years 1931 to 1936, inclusive.

The adjustments have not been agreed to. Mr. O. H. Tufts, C. P. A., disagrees with the adjustments.

[fol. 14] Virginia Hotel Corporation of Lynchburg,

Schedule 1—Year Ended Dec. 31, 1938

Adjustments to Net Income

Net income as disclosed by return	$11,688.90
As corrected	14,805.40
Net adjustment as computed below	3,116.50

Unallowable deductions and additional income:

(a) Depreciation	$3,046.50	
(b) Capital stock tax	70.00	
Total		3,116.50
Net adjustment as above		3,116.50

Schedule 1-A

Explanation of Items

(a) Depreciation	3,046.50
See Exhibit A	
(b) Capital stock tax	70.00

Capital stock tax paid for the fiscal year ended June 30, 1938. This tax accrued on July 1, 1937.

Note: Agent's computation of taxes, Schedule 2—pages 3 and 4, omitted from copy.

[fol. 15] Virginian Hotel Corporation of Lynchburg

	Reserve 12-31-37	Depreciation allowable	Reserve 12-31-38
Furn. & Fixtures	56,722.75	690.47	57,413.22
Carpets	30,534.[illegible]	263.14	30,797.47
Air Conditioning Equip	....	65.34	65.34
Cafe Equipment	23,407.03	147.67	23,554.70
Laundry Equipment	6,273.80	102.91	6,376.71
Ice Plant	2,447.32	25.94	2,473.26
	119,385.23	1,295.47	120,680.70

Depreciation claimed	4,341.97
Depreciation allowable	1,295.47
	3,046.50

Depreciation

Virginia Hotel Corporation of Lynchburg—Exhibit B—Contd.

	Year in Which Purchased	Totals	Additions	Reserve 12-31-37	Balance	Estimate of Life	Years in Service	Beginning Life	Deprecia-tion 1938
Furn. & Fix.	1913 to 6-1-27	(a)	38,400.20	38,400.20	....	20 yr.	10½ to 24		None
	1927	....	1,730.33	1,730.33	....	20 yr.	10½	9½	None
	1928	....	3,087.23	2,932.84	154.39	"	9½	10½	14.70
	1929	....	692.35	588.54	103.81	"	8½	11½	9.02
	1930	....	1,789.54	1,342.12	447.42	"	7½	12½	35.79
	1931	....	15,033.55	9,771.83	5,261.72	"	6½	13½	389.76
	1932	....	2,733.92	1,503.64	1,230.28	"	5½	14½	84.85
	1934	....	999.63	349.89	649.74	"	3½	16½	39.38
	1935	....	184.57	55.90	128.67	"	2½	17½	7.35
	1936	....	134.76	20.22	114.54	"	1½	18½	6.19
	1937	65,330.93	544.85	27.24	517.61	"	½	19½	26.54
	1938	68,406.69	3,075.76	....	3,075.76	"	..	20	76.89
			68,406.69	56,722.75	11,683.94				690.47
Carpets	1913 to 6-1-27	(a)	19,341.70	19,341.70	....	12½	10½ to 24	..	......
	1927	....	1,247.90	1,247.90	....	"	10½	2	......
	1928	....	2,745.58	2,745.58	....	"	9½	3	......
	1929	....	2,395.99	2,395.99	....	"	8½	4	......
	1931	....	4,406.74	4,296.56	110.18	"	6½	6	18.36
	1935	....	814.36	305.40	508.96	"	2½	10	50.90
	1936	....	686.73	154.51	532.22	"	1½	11	48.38
	1937	32,261.54	622.54	46.69	575.85	"	½	12	47.99
	1938	34,699.33	2,437.79	....	2,437.79	"	..	12½	97.51
			34,699.33	30,534.33	4,165.00				263.14

(a) Hotel was opened in 1913. As of June 1, 1927 the present owners purchased the equipment. The original purchase of equipment, therefore, covered assets which had been put in service between 1913 and 1937.

[fol. 17]

								Remaining	
Air Con. Equip.	1938	2,613.67	2,613.67	....	2,612.67	20 yrs.	..	20	65.34
			2,612.67	....	2,613.67				65.34
Cafe Equip.	1913 to 6–1–27	....	7,234.00	7,234.00	None	20 yrs.	10½ to 24	..	None
	1927	....	9,599.67	9,599.67	None	"	10½	9½	None
	1928	....	3,899.40	3,699.40	194.73	"	9½	10½	18.55
	1929	....	659.08	560.20	98.88	"	8½	11½	8.60
	1930	....	214.81	161.10	53.71	"	7½	12½	4.30
	1931	....	3,057.04	1,987.05	1,069.99	"	6½	13½	79.26
	1932	....	242.05	133.15	108.90	"	5½	14½	7.51
	1934	....	49.86	17.46	32.40	"	3½	15½	1.96
	1936	25,050.64	100.00	15.00	85.00	"	1½	18½	4.59
	1938	25,966.61	915.97	....	915.97	"	..	20	22.90
			25,966.61	23,407.03	2,559.58				147.67
Laundry Equip.	1927	....	4,103.21	4,103.21	None	20 yrs.	10½	..	......
	1928	....	175.00	167.25	7.75	"	9½	10½	.74
	1931	....	1,011.23	657.28	353.95	"	6½	13½	26.22
	1932	7,736.79	2,447.35	1,346.06	1,101.29	"	5½	14½	75.95
			7,736.79	6,273.80	1,462.99				102.91
Ice Plant	1927	....	1,822.43	1,822.43	....	20 yrs.	10½	9½	......
	1928	....	121.51	115.42	6.09	"	9½	10½	.58
	1929	....	325.00	276.25	48.75	"	8½	11½	4.24
	1931	....	241.65	157.09	84.56	"	6½	13½	6.26
	1932	....	33.68	18.53	15.15	"	5½	14½	1.04
	1933	....	122.96	46.35	56.61	"	4½	15½	3.65
	1936	2,722.23	75.00	11.25	63.75	"	1½	18½	3.45
	1938	2,990.67	268.44	....	268.44	"	..	20	6.72
			2,990.67	2,447.32	543.35				25.94

(Here follows 1 paster, Exhibit "C", side folios 18-19)

Exhibit "C" to Petition

Virginian Hotel Corporation of Lynchburg
Lynchburg, Virginia

		Asset Additions	Depreciation Allowed or Allowable 1927–30 Allowed	1931 Allowable	1932 Allowable	1933 Allowable	1934 Allowable	1935 Allowable	1936 Allowed	1937 Allowed	Total
Furniture and Fixtures:	1927	$38,400.20	$13,440.07	$1,920.01	$1,920.01	$1,920.01	$1,920.01	$1,920.01	$2,637.68	$1,920.02	$27,597.82
	1927	1,730.33	605.61	86.52	86.52	86.52	86.52	86.52	118.85	86.53	1,243.59
	1928	3,087.23	771.80	154.36	154.36	154.36	154.36	154.36	212.00	308.72	2,064.38
	1929	692.35	103.86	34.62	34.62	34.62	34.62	34.62	47.56	69.24	393.76
	1930	1,789.54	89.47	89.48	89.48	89.48	89.48	89.48	122.92	178.95	838.74
	1931	15,033.55	....	375.84	751.68	751.68	751.68	751.68	1,032.65	1,503.36	5,918.57
	1932	2,733.92	....	....	68.35	136.70	136.70	136.70	187.79	273.39	939.63
	1934	999.63	....	....	....	....	24.99	49.98	68.67	99.97	243.61
	1935	184.57	....	....	....	....	....	4.61	17.14	18.46	40.21
	1936	134.76	....	....	....	....	....	....	4.63	13.48	18.11
	1937	544.85	....	....	....	....	....	....	....	27.24	27.24
		$65,330.93	$15,010.81	$2,660.83	$3,105.02	$3,173.37	$3,198.36	$3,227.96	$4,449.95	$4,499.36	$39,325.66
Carpets:	1927	$19,341.70	$10,154.41	$1,547.34	$1,547.34	$1,547.34	$1,547.34	$1,547.34	$1,450.59	$..........	$19,341.70
	1927	1,247.90	657.75	99.83	99.83	99.83	99.83	99.83	91.00	....	1,247.90
	1928	2,745.58	1,029.68	219.65	219.65	219.65	219.65	219.65	219.65	219.65	2,567.23
	1929	2,395.99	529.10	191.68	191.68	191.68	191.68	191.68	191.68	191.68	1,870.86
	1931	4,406.74	....	176.27	352.54	352.54	352.54	352.54	352.54	352.54	2,291.51
	1935	814.36	....	....	....	....	....	32.57	65.15	65.15	162.87
	1936	686.73	....	....	....	....	....	....	27.47	54.94	82.41
	1937	622.54	....	....	....	....	....	....	....	(1) 48.91	48.91
		$32,261.54	$12,370.94	$2,234.77	$2,411.04	$2,411.04	$2,411.04	$2,443.61	$2,398.08	$932.87	$27,613.39
Cafe Improvements:	1927	$7,232.40	$2,531.34	$361.62	$361.62	$361.62	$361.62	$361.62	(2) $496.79	$361.65	$5,197.88
	1927	9,599.67	3,359.86	479.98	479.98	479.98	479.98	479.98	659.39	480.02	6,899.17
	1928	3,894.13	973.53	194.71	194.71	194.71	194.71	194.71	267.48	389.41	2,602.97
	1929	659.08	98.85	32.95	32.95	32.95	32.95	32.95	45.27	65.91	374.78
	1930	214.81	10.74	10.74	10.74	10.74	10.74	10.74	14.75	21.48	100.67
	1931	3,057.04	....	76.43	152.85	152.85	152.85	152.85	209.98	305.70	1,203.51
	1932	242.05	....	....	6.05	12.10	12.10	12.10	16.63	24.21	83.19
	1934	49.86	....	....	....	....	1.25	2.49	3.43	4.99	12.16
	1936	100.00	....	....	....	....	....	....	3.44	10.00	13.44
		$25,049.04	$6,974.32	$1,156.43	$1,238.90	$1,244.95	$1,246.20	$1,247.44	$1,717.16	$1,663.37	$16,488.77
[fol. 19] Laundry Equipment:	1927	$4,103.21	$1,436.12	$205.16	$205.16	$205.16	$205.16	$205.16	$281.85	$205.17	$2,948.94
	1928	175.00	44.75	8.75	8.75	8.75	8.75	8.75	12.02	17.50	118.02
	1931	1,011.23	....	25.28	50.56	50.56	50.56	50.56	69.46	101.12	398.10
	1932	2,447.35	....	....	61.18	122.37	122.37	122.37	168.10	244.74	841.13
		$7,736.79	$1,480.87	$239.19	$325.65	$386.84	$386.84	$386.84	$531.43	$568.53	$4,306.19
Ice Machine:	1927	$1,822.43	$637.84	$91.12	$91.12	$91.12	$91.12	$91.12	$125.18	$91.15	$1,309.77
	1928	121.51	30.37	6.08	6.08	6.08	6.08	6.08	8.35	12.15	81.27
	1929	325.00	48.75	16.25	16.25	16.25	16.25	16.25	22.32	32.50	184.82
	1931	241.65	....	6.04	12.08	12.08	12.08	12.08	16.60	24.17	95.13
	1932	33.68	....	....	.84	1.68	1.68	1.68	2.32	3.37	11.57
	1933	102.96	....	....	....	2.57	5.15	5.15	7.08	10.30	30.25
	1936	75.00	....	....	....	....	....	....	2.58	7.50	10.08
		$2,722.23	$716.96	$119.49	$126.37	$129.78	$132.36	$132.36	$184.43	$181.14	$1,722.89
Ford Truck:	1933	$150.00	....	....	....	$18.75	$37.50	$37.50	$37.50	$18.75	$150.00
Grand Totals..................		$133,250.53	$36,553.90	$6,410.71	$7,206.98	$7,364.73	$7,412.30	$7,475.71	$9,318.55	$7,864.02	$89,606.90
Depreciation claimed on Income Returns.......			36,553.90	12,532. 5	14,102.55	14,409.36	11,909.41	11,179.84	12,456.02	7,864.02	121,007.15
Excess Depreciation Deducted and not used to reduce Taxable Income....................			$..........	$6,121.34	$6,895.57	$7,044.63	$4,497.11	$3,704.13	(3) $3,137.47	$..........	$31,400.25
Net Losses per Returns......................			(Gain)	$8,912.97	$10,506.07	$8,672.23	$4,515.16	$6,511.52	$3,137.47 (4)	(Gain)	

NOTE:

	1937	544.85	....	....	....	....	....	....	....	27.24	27.24
		$65,330.93	$15,010.81	$2,660.83	$3,105.02	$3,173.37	$3,1[illegible].36	$3,227.90	$4,449.95	$4,499.36	$39,325.66
Carpets:	1927	$19,341.70	$10,154.41	$1,547.34	$1,547.34	$1,547.34	$1,547.34	$1,547.34	$1,450.59	$.........	$19,341.70
	1927	1,247.90	657.75	99.83	99.83	99.83	99.83	99.83	91.00	....	1,247.90
	1928	2,745.58	1,029.68	219.65	219.65	219.65	219.65	219.65	219.65	219.65	2,567.23
	1929	2,395.99	529.10	191.68	191.68	191.68	191.68	191.68	191.68	191.68	1,370.86
	1931	4,406.74	....	176.27	352.54	352.54	352.54	352.54	352.54	352.54	2,291.51
	1935	814.36	....	....	....	....	....	32.57	65.15	65.15	162.87
	1936	686.73	....	....	....	....	....	....	27.47	54.94	82.41
	1937	622.54	....	....	....	....	....	....	....	(1) 48.91	48.91
		$32,261.54	$12,370.94	$2,234.77	$2,411.04	$2,411.04	$2,411.04	$2,443.61	$2,398.08	$932.87	$27,613.39
Cafe Improvements:	1927	$7,232.40	$2,531.34	$361.62	$361.62	$361.62	$361.62	$361.62	(2) $496.79	$361.65	$5,197.88
	1927	9,599.67	3,359.86	479.98	479.98	479.98	479.98	479.98	659.39	480.02	6,899.17
	1928	3,894.13	973.53	194.71	194.71	194.71	194.71	194.71	267.48	389.41	2,603.97
	1929	659.08	13.85	32.95	32.95	32.95	32.95	32.95	45.27	65.91	374.78
	1930	214.81	10.74	10.74	10.74	10.74	10.74	10.74	14.75	21.48	100.67
	1931	3,057.04	....	76.43	152.85	152.85	152.85	152.85	209.98	305.70	1,203.51
	1932	242.05	....	....	6.05	12.10	12.10	12.10	16.63	24.21	83.19
	1934	49.86	....	....	....	....	1.25	2.49	3.43	4.99	12.16
	1936	100.00	....	....	....	....	....	....	3.44	10.00	13.44
		$25,049.04	$6,974.32	$1,156.43	$1,238.90	$1,244.95	$1,246.20	$1,247.44	$1,717.16	$1,663.37	$16,488.77
[fol. 19] Laundry Equipment:	1927	$4,103.21	$1,436.12	$205.16	$205.16	$205.16	$205.16	$205.16	$281.85	$205.17	$2,948.94
	1928	175.00	44.75	8.75	8.75	8.75	8.75	8.75	12.02	17.50	118.02
	1931	1,011.23	....	25.28	50.56	50.56	50.56	50.56	69.46	101.12	398.10
	1932	2,447.35	....	....	61.18	122.37	122.37	122.37	168.10	244.74	841.13
		$7,736.79	$1,480.87	$239.19	$325.65	$386.84	$386.84	$386.84	$531.43	$568.53	$4,306.19
Ice Machine:	1927	$1,822.43	$637.84	$91.12	$91.12	$91.12	$91.12	$91.12	$125.18	$91.15	$1,309.77
	1928	121.51	30.37	6.08	6.08	6.08	6.08	6.08	8.35	12.15	81.27
	1929	325.00	48.75	16.25	16.25	16.25	16.25	16.25	22.32	32.50	184.82
	1931	241.65	....	6.04	12.08	12.08	12.08	12.08	16.60	24.17	95.13
	1932	33.68	....	....	.84	1.68	1.68	1.68	2.32	3.37	11.57
	1933	102.96	....	....	....	2.57	5.15	5.15	7.08	10.30	30.25
	1936	75.00	....	....	....	....	....	....	2.58	7.50	10.08
		$2,722.23	$716.96	$119.49	$126.37	$129.78	$132.36	$132.36	$184.43	$181.14	$1,722.89
Ford Truck:	1933	$150.00	....	....	....	$18.75	$37.50	$37.50	$37.50	$18.75	$150.00
Grand Totals..................		$133,250.53	$36,553.90	$6,410.71	$7,206.98	$7,364.73	$7,412.30	$7,475.71	$9,318.55	$7,864.02	$89,606.90
Depreciation claimed on Income Returns.......			36,553.90	12,532.05	14,102.55	14,409.36	11,909.41	11,179.84	12,456.02	7,864.02	121,007.15
Excess Depreciation Deducted and not used to reduce Taxable Income.....................			$.........	$6,121.34	$6,895.57	$7,044.63	$4,497.11	$3,704.13	(3) $3,137.47	$.........	$21,400.25
Net Losses per Returns......................			(Gain)	$8,912.97	$10,505.07	$8,872.33	$4,515.16	$6,511.52	$3,137.47 (4)	(Gain)	

NOTE:

(1) Half rate 1937 additions..	$24.90	
Add: To make total agree with amount claimed on return—$932.87.....	24.01	
		$48.91
(2) Depreciation allowable on 12½ year life..................................	$2,398.08	
Depreciation claimed on return..	924.56	
Additional depreciation allowable..		1,473.52
(3) Total depreciation claimed on return......................................	$10,982.50	
Additional allowable on carpets (2)..	1,473.52	
Total allowed but not less than allowable......................................		12,456.02
(4) Net loss—return..	$1,663.95	
Additional allowable depreciation carpets (2)..................................	1,473.52	
Corrected loss—return..		3,137.47

[fol. 20] **Exhibit "D" to Petition**

Virginian Hotel Corporation of Lynchburg
Lynchburg, Virginia

Purchased	Additions	Reserve 12-31-37	Balance	Est. Life Years	Years in Service	Remaining Life Years	Depreciation 1938

Furniture and Fixtures:

[fol. 20] **Exhibit "D" to Petition**

Virginian Hotel Corporation of Lynchburg
Lynchburg, Virginia

Furniture and Fixtures:

Purchased	Additions	Reserve 12-31-37	Balance	Est. Life Years	Years in Service	Remaining Life Years	Depreciation 1938
1927	$38,400.20	$27,597.82	$10,802.38	20	10½	9½	$1,137.09
1927	1,730.33	1,243.59	486.74	"	10½	9½	51.24
1928	3,087.23	2,064.38	1,022.85	"	9½	10½	97.41
1929	692.35	393.76	298.59	"	8½	11½	25.96
1930	1,789.54	838.74	950.80	"	7½	12½	76.06
1931	15,033.55	5,918.57	9,114.98	"	6½	13½	675.18
1932	2,733.92	939.63	1,794.29	"	5½	14½	123.74
1934	999.63	243.61	756.02	"	3½	16½	45.82
1935	184.57	40.21	144.36	"	2½	17½	8.25
1936	134.76	18.11	116.65	"	1½	18½	6.31
1937	544.85	27.24	517.61	"	½	19½	26.54
1938	3,075.76	....	3,075.76	"	..	20	76.89
	$68,406.69	$39,325.66	$29,081.03				$2,350.49

Carpets:

Purchased	Additions	Reserve 12-31-37	Balance	Est. Life Years	Years in Service	Remaining Life Years	Depreciation 1938
1927	$19,341.70	$19,349.70	$.........				
1927	1,247.90	1,241.90	....				
1928	2,745.58	2,567.23	178.35	12½	9½	3	$59.45
1929	2,395.99	1,870.86	525.13	"	8½	4	131.28
1931	4,406.74	2,291.51	2,115.23	"	6½	6	352.54
1935	814.36	162.87	651.49	"	2½	10	65.15
1936	686.73	82.41	604.32	"	1½	11	54.94
1937	622.54	48.91	573.63	"	½	12	47.80
1938	2,437.79	....	2,437.79	"	..	12½	97.51
	$34,699.33	$27,613.39	$7,085.94				$808.67

Improvements-Cafe:

Purchased	Additions	Reserve 12-31-37	Balance	Est. Life Years	Years in Service	Remaining Life Years	Depreciation 1938
1927	$7,232.40	$5,197.88	$2,034.52	20	10½	9½	$214.16
1927	9,599.67	6,899.17	2,700.50	"	10½	9½	284.26
1928	3,894.13	2,603.97	1,290.16	"	9½	10½	122.87
1929	659.08	374.78	284.30	"	8½	11½	24.72
1930	214.81	100.67	114.14	"	7½	12½	9.13
1931	3,057.04	1,203.51	1,853.53	"	6½	13½	137.30
1932	242.05	83.19	158.86	"	5½	14½	10.96
1934	49.86	12.16	37.70	"	3½	16½	2.28
1936	100.00	13.44	86.56	"	1½	18½	4.68
1938	915.97	....	915.97	"	..	20	22.90
	$25,965.01	$16,488.77	$9,476.24				$833.26

[fol. 21]

Laundry Equipment:

1927	$4,103.21	$2,948.94	$1,154.27	20	10½	9½	$121.50
1928	175.00	118.02	56.98	"	9½	10½	5.43
1931	1,011.23	398.10	613.13	"	6½	13½	45.42
1932	2,447.35	841.13	1,606.22	"	5½	14½	110.77
	$7,736.79	$4,306.19	$3,430.60				$283.12

Ice Machine:

1927	$1,822.43	$1,309.77	$512.66	20	10½	9½	$53.96
1928	121.51	81.27	40.24	"	9½	10½	3.83
1929	325.00	184.82	140.18	"	8½	11½	12.19
1931	241.65	95.13	146.52	"	6½	13½	10.85
1932	33.68	11.57	22.11	"	5½	14½	1.52
1933	102.96	30.25	72.71	"	4½	15½	4.69
1936	75.00	10.08	64.92	"	1½	18½	3.51
1938	268.44	....	268.44	"	..	20	6.71
	$2,990.67	$1,722.89	$1,267.78				$97.26

Air Conditioning Equipment:

1938	$2,613.67	$.........	$2,613.67	20	..	20	$65.34
	$142,412.16	$89,456.90	$52,955.26				$4,438.14

[fol. 22] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

ANSWER—Filed January 30, 1941

Comes now the Commissioner of Internal Revenue by his Attorney J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein admits and denies as follows:

1. Admits that the petitioner is a corporation chartered and existing under and by virtue of the laws of the Commonwealth of Virginia, with its principal office at Church and Eighth Streets, Lynchburg, Virginia, and that its Federal income tax return for the calendar year 1938 was filed with the Collector of Internal Revenue for the District of Virginia at Richmond, Virginia.

2. Admits that a notice of deficiency was mailed to the petitioner on September 11, 1940, and that a true and correct copy of the said notice of deficiency is attached to the petition and marked Exhibit A. Denies that a true and correct copy of the Revenue Agent's Report is attached to the petition.

3. Admits that the taxes in controversy are Federal income and excess-profits taxes for the calendar year ended December 31, 1938, and that the deficiencies as determined by the Commissioner of Internal Revenue are $416.94 and $138.32, respectively.

[fol. 23] 4. Denies that the Commissioner of Internal Revenue erred in manner and form as set forth and alleged in sub-paragraphs (a), (b), (c), (d), and (e) of paragraph 4 of the petition.

5. Denies all of the allegations of fact as set forth and alleged in sub-paragraphs (a), (b), (c), (d), (e), (f), (g), (h), (i), and (j) of paragraph 5 of the petition.

6. Denies that the petitioner is entitled to the relief prayed for in sub-paragraphs (a), (b), and (c) of paragraph 6 of the petition.

7. Denies generally and specifically each and every allegation of fact contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the appeal be denied.

(Signed) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: Chester A. Gwinn, Division Counsel; E. L. Corbin, Special Attorney, Bureau of Internal Revenue.
elc/tls 1-27-41.

[fol. 24] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

STIPULATION OF FACTS—Filed November 10, 1941

It is hereby stipulated and agreed by and between the parties hereto, by their respective agent and attorney, that the following facts are true and that the same may be so taken and considered by the Board of Tax Appeals as offered in evidence by the parties to this proceeding:

1. The petitioner is a corporation chartered under the laws of the State of Virginia in the year 1930. Its principal office is located at Church and Eighth Streets, Lynchburg, Virginia, and it has continuously since January 1, 1931, operated a hotel in the City of Lynchburg, Virginia, as lessee.

2. The petitioner filed its income tax return for the calendar year 1938 with the Collector of Internal Revenue for the District of Virginia, at Richmond, Virginia, and reported thereon a net taxable income of $11,688.90.

3. The amount of $4,341.97, depreciation, and the amount of $70.00, Federal capital stock tax paid in the year 1938, were claimed as deductions from gross income on the said income tax return of the petitioner.

4. The respondent disallowed $3,046.50 of the aforesaid depreciation deduction and all of the aforesaid $70.00 Federal capital stock tax deduction and issued an alleged notice of deficiency, dated September 11, 1940, a copy of which is

attached to the petition of the petitioner heretofore filed in [fol. 25] this cause.

5. The Lynchburg Hotel Corporation caused a hotel, known as "The Virginian Hotel", to be erected at the corner of Church and Eighth Streets, Lynchburg, Virginia, about 1913, which has been leased to operating individuals and/or corporations at all times since its completion.

6. In 1927, prior to June 1st, the said hotel was operated by the Virginian Hotel, Incorporated, under a lease expiring on January 15, 1939, copy of which is attached and marked Exhibit A. The said hotel was completely furnished and equipped at this time, the furniture and equipment therein being the property of the lessee, the Virginian Hotel, Incorporated.

7. On June 1, 1927, with the written consent of the Lynchburg Hotel Corporation, the owner, A. F. Young and R. E. Young assumed the then existing lease of the said hotel and purchased from the Virginian Hotel, Incorporated, all of its furniture and equipment in the said hotel for the sum of $70,899.94.

8. A. F. Young and R. E. Young operated the said hotel under the partnership name of "Virginian Hotel" from June 1, 1927, to December 31, 1930. Effective January 1, 1931, the said partnership was incorporated as the Virginian Hotel Corporation of Lynchburg, the petitioner herein, and all of the issued capital stock of the said corporation, 405 shares, par $100.00, was issued to A. F. Young and R. E. Young, except qualifying shares, for the net book value of the partnership assets. "Values of the assets remained unchanged after the incorporation since no change in actual ownership was involved" (page 1, Preliminary [fol. 26] Statement, Exhibit B, annexed to petition). The said Virginian Hotel Corporation of Lynchburg, the petitioner herein, has continuously operated the said hotel since January 1, 1931, as lessee. No relationship has existed at any time between the holding corporation and the leasing corporation, their respective officers, directors and stockholders, other than lessor and lessee.

9. The total amount expended by the partnership and the petitioner for furniture and equipment, including replacements capitalized, from June 1, 1927, to December 31, 1938, is as follows:

	Furniture and Fixtures	Carpets	Cafe Improvements	Laundry Equipment	Ice Machine	Total
Purchased from prior Lessee June 1, 1927	$38,400.20	$19,341.70	$7,232.40	$4,103.21	$1,822.43	$70,899.94
Additions 1927	$1,730.33	$1,254.90	$9,599.67	$........	$........	$12,584.90
1928	3,087.23	2,745.58	3,894.13	175.00	121.51	10,023.45
1929	692.35	2,395.99	659.08	....	325.00	4,072.42
1930	1,789.54	....	214.81	....	....	1,997.35
1931	15,033.55	4,406.74	3,057.04	1,011.23	241.65	23,750.21
1932	2,733.92	....	242.05	2,447.35	33.68	5,457.00
1933	....	....	....	....	102.96	102.96
1934	999.63	....	49.86	....	....	1,049.49
1935	184.57	814.36	....	....	....	998.93
1936	134.76	686.73	100.00	....	75.00	996.49
1937	544.85	622.54	....	....	....	1,167.39
1938	3,075.76	2,437.79	915.97	....	268.44	6,697.96
Total Additions	$30,006.49	$15,357.63	$18,732.61	$3,633.58	$1,168.24	$68,898.55
Grand Totals	$68,406.69	$34,699.33	$25,965.01	$7,736.79	$2,990.67	$139,798.49

The above does not include the amount of $2,613.67 expended in 1938 for air conditioning equipment, depreciation of which is not at issue herein.

[fol. 27] 10. Depreciation has been charged each year since June 1, 1927, at the following straight line rates, allowance having been made for fully depreciated items; and deductions have been claimed therefor on the income tax returns:

Furniture and Fixtures	10%
Carpets	15%
Cafe Improvements	10%
Laundry Equipment	10%
Ice Machine	10%

11. The respondent did not question the depreciation deduction as claimed each year through the year 1937. In arriving at the amount of depreciation allowable for the year 1938 the Revenue Agent determined that depreciation should be computed on the basis outlined on pages 5, 6, and 7 of Exhibit B annexed to the petition, which is by reference included in and made a part of this stipulation, and he computed the allowable depreciation for the year 1938 to be $1,295.47 and disallowed $3,046.50 of the amount claimed as a deduction by the petitioner.

12. The respondent approved the Revenue Agent's report and made it the basis of his notice of deficiency, from which the appeal was taken.

13. The partnership had a net gain for each of the years from June 1, 1927, to December 31, 1930, inclusive, and the entire amount of depreciation deducted on the income tax returns for those years served to reduce taxable income. The petitioner sustained a net loss for each of the years 1931, 1932, 1933, 1934, 1935 and 1936, and the entire amount of depreciation deducted on the income tax returns for those years did not serve to reduce the taxable income. The year 1937 resulted in a net gain and the depreciation deducted on the income tax return for that year served to reduce [fol. 28] taxable income. If the depreciation is recomputed for the years prior to the year 1938, using the amount claimed as a deduction for the years which resulted in a net gain and the amount allowable at the respondent's rates

as determined for 1938 for the years which resulted in a net loss, the results will be:

	Depreciation			Net Loss Tax Returns
	Claimed	Allowable	Excess	
Years 1927–1930, inclusive	$36,553.90	$36,553.90	....	$ Gain
1931	12,532.05	6,410.71	$6,121.34	8,912.97
1932	14,102.55	7,206.98	6,895.57	10,505.07
1933	14,409.36	7,364.73	7,044.63	8,872.33
1934	11,875.58	7,412.30	4,497.11	4,481.33
Correction-Sch. L., 1935	33.83	....	....	+ 33.83
1935	11,179.84	7,475.71	3,704.13	6,511.52
1936	10,982.50	9,318.55	3,137.47	1,663.95
Correction resulting from using respondent's rates 1931–5	+ 1,473.52	....	....	+1,473.52
1937	7,864.02	7,864.02	....	Gain
Totals..............	$121,007.15	$89,606.90	$31,400.25	$42,454.52

14. If the Board determines that the petitioner may recompute its depreciation for the years prior to the year 1938 as set forth above, and that the amount of $31,400.25 may be restored to the undepreciated balance of the respective assets at December 31, 1937, the correct allowable depreciation for the year 1938, computed according to the respondent's rates, will be $4,438.14. If the Board determines that the amount of $31,400.25 may not be restored to the undepreciated balance then the correct allowable depreciation for 1938 will be $1,295.47, and the Board may so enter its order.

15. The petitioner accrued at December 31, 1937, and deducted from gross income on its income tax return for the [fol. 29] calendar year 1937, a capital stock tax of $55.00, computed according to the provisions of Section 105 of the Revenue Act of 1935 as amended by Section 401 of the Revenue Act of 1936, as follows:

Adjusted Declared Value, June 30, 1937—Form 707	$48,336.05
Additions:	
Net Income for the year 1937	7,235.91
	$55,571.96
Deductions	None
Adjusted Declared Value, June 30, 1938	$55,571.96
Tax at $1.00 for each $1,000.00	$55.00

On filing its capital stock tax return for the capital stock tax year ended June 30, 1938, the petitioner declared a value of $125,000.00 for its capital stock and showed a tax liability of $125.00, or $70.00 more than the amount that it had accrued at December 31, 1937.

16. The petitioner claimed the said $70.00 additional capital stock tax paid in 1938 as a deduction from gross income on its income tax return for the calendar year 1938.

17. The respondent disallowed the said $70.00 additional capital stock tax as a deduction from gross income for the calendar year 1938, and contends that it accrued July 1, 1937, and that it was an allowable deduction from gross income for the petitioner's calendar year 1937.

(Signed) O. H. Tufts, Agent for Petitioner. (Signed) J. P. Wenchel, R. E. S., Chief Counsel, Bureau of Internal Revenue.

[fol. 30] Exhibit "A" to Stipulation of Facts

Virginian Hotel Corporation of Lynchburg—Docket No. 105828. Exhibit A annexed to Stipulation of Facts

This Contract and Lease made and entered into this 24th day of May, 1923, between The Lynchburg Hotel Corporation, a corporation organized and doing business under the laws of the State of Virginia, hereinafter styled "lessor", of the one part, and The Virginian Hotel, Incorporated, a corporation organized and doing business under the laws of the State of Virginia, hereinafter styled "lessee," of the other part,

Witnesseth: Whereas the contract of lease for the property of the said lessor in the City of Lynchburg, Va., known as "The Virginian Hotel," has been changed and amended several times by mutual consent; and

Whereas the parties hereto are the present lessor and lessee of the said property and have agreed to further changes and amendments of said contract of lease; and

Whereas it is deemed desirable to embody in this one formal contract and lease the entire agreement between the parties with respect to said property;

Now, therefore, in consideration of the premises and of the mutual obligations and liabilities herein assumed by

the parties hereto, the said parties do hereby contract and agree as follows:

I. That upon, and as of the date of, the execution hereof, all other contracts between the parties hereto with reference to the lease of the said property of the lessor, and especially the contract dated August 31st, 1911, between the lessor and R. L. O'Neal and C. C. Beeber, (which has been assumed by said lessee) and all amendments thereof, shall be, and are hereby, cancelled, annulled and abrogated, except as merged in this contract.

[fol. 31] II. The said lessor doth hereby lease, unto the said lessee, for the period hereinafter set forth that certain property of the lessor in the City of Lynchburg, Va., at the corner of Eighth and Church Streets, known as "The Virginian Hotel," with all the appurtenances thereto belonging or in any wise appertaining; and especially the right to use the alley in the rear of said Hotel for all purposes properly incident to the conduct of said Hotel, which said use of said alley shall not be unreasonably curtailed or restricted by grants of easements by the lessor to others for use thereof.

III. That said lessee shall continuously and uninterruptedly, throughout the term hereinafter specified, maintain and operate the said property as a first class, modern hotel; and shall likewise maintain the equipment, appointments and furnishings of said hotel in accordance with the standards of first class hotels of comparable size in Cities of like character and size to Lynchburg.

IV. That said lessor shall, as soon as practicable cause to be constructed upon the said hotel building an additional story containing additional rooms and shall at the same time cause the present assembly hall in said building to be converted and reconstructed into sleeping rooms. The said construction work shall be done in accordance with plans and specifications to be approved by said lessee. And it is specifically agreed that the natural and reasonable inconvenience to the operation of the said hotel by the lessee during the said construction work, shall not be the basis of any claim for abatement of rent during said period, nor of any claim for damages. Provided that this Clause shall not be construed as a waiver by the lessee of any right to assert proper claim for any physical damage that may be suffered

by it on account of the destruction of, or injury to, the said premises or any of its furniture, equipment or appointments, by said lessor or any of its agents in the course of said construction work.

[fol. 32] V. The said lessor shall keep an accurate account of its expenditures in the construction work to be done by it as herein set forth, and shall upon completion thereof; submit a statement of said account to the said lessee for inspection and audit. And upon the said completion of the said construction work, the said lessor shall turn over and deliver to the said lessee the said additional story and additional rooms for operation hereunder.

VI. The said lessee shall, at its own expense furnish and equip the said additional story and additional rooms as rapidly after said delivery thereof to it as the said additional rooms may be needed in the operation of the said hotel hereunder. And said furniture and equipment shall be of a character and quality in harmony and keeping with the present furniture and equipment of the said hotel as now operated.

VII. The said lessee shall insure, and keep continually insured, all of its furniture and equipment that is now in said hotel or that may hereafter be installed therein, for its fair value, in reputable insurance companies authorized and licensed to do business in the State of Virginia; and shall cause all policies of said insurance to be assigned to, or properly indorsed for, the protection of the said "lessor," and shall deliver said policies, as they shall be severally issued and renewed, to the said lessor.

VIII. The said lessee shall preserve all its furniture and equipment now in said hotel, or that may be hereafter installed therein, free from liens of every character that may lessen the value thereof as security to said lessor. And at any time that the said lessor may demand it, the said lessee shall cause a proper deed of trust to be executed, conveying all of said furniture and equipment to a trustee, in trust to secure the said lessor against any default of the said lessee in the performance of its obligations hereunder.

IX. The period of duration of this lease shall extend from the date of the execution hereof to the expiration of fifteen

[fol. 33] years after the completion of the additional story and additional rooms herein provided for, and the formal delivery thereof to said lessee for occupancy and operation hereunder.

X. The said lessee, as rent for the property hereby leased, from the execution hereof to the date of the completion and delivery of the additional story and additional rooms as hereinabove provided, shall pay to the said lessor an annual rental of twenty-four thousand dollars ($24,000.00) payable in equal monthly installments on the first day of each calendar month. And from the said completion and delivery of the said additional story and additional rooms to the end of the full term of fifteen years thereafter, the said lessee shall pay an annual rental of twenty-four thousand dollars ($24,000.00) plus an additional annual rental of a sum equal to 12% of the total amount expended by the said lessor in the actual construction of the said additional story and additional rooms, in accordance with the properly audited statement thereof as hereinabove provided. The said total annual rental from the date of said completion and delivery of the said additional story and additional rooms shall likewise be payable in equal monthly installments on the first day of each calendar month. It is specifically agreed between the parties hereto that in the event the taxes on the said leased property shall be increased during the term of this lease, either by increase of assessed value or of tax rate, over and above the amount of taxes applicable as of the date of the completion of the improvements herein provided for and their assessment for taxes as part of the leased premises, then the said lessee shall pay to the said lessor, as additional rental, a sum equal to the said *increase* of taxes, said amount to be due and payable with the October installments of rent in each year that such increased tax shall be payable by said lessor.

Marginal Indorsement

It is understood and agreed between the Lunchburg Hotel Corporation and A. F. Young and Rosa E. Young, the assignees of this lease, that the monthly rent payable under this lease from June 1, 1927, until its expiration on January 15, 1939, is $3165.77. This does not cover any addi-

tional charges for taxes as provided in C*al*use X of this lease and the addition thereto.

Signed June 1, 1927. Lynchburg Hotel Corp. By J. T. Noell, Jr., Sec'y. A. F. Young, Rosa E. Young.

Marginal Endorsement

It is understood that "the said *increase* of taxes" to be paid the Lessor as provided in this paragraph, X, shall mean any increase in the sum total of all taxes—State, City and Federal that may be assessed against the Lynchburg Hotel Corporation.

J. T. Noell, Jr., Sec'y. F. C. Crider, Sec'y.

XI. In the event the said hotel shall be destroyed or rendered untenantable as a hotel by fire or otherwise, without fault on the part of the lessee, then this lease shall terminate, and no rent shall accrue hereunder thereafter; [fol. 34] and no obligation shall rest upon either the lessor or lessee to rebuild the said hotel.

XII. In the event the said hotel be damaged by fire or otherwise, without fault on the part of the said lessee, not to the extent of rendering the same wholly untenantable as a hotel, but only to the extent of depriving said lessee of the use of a part thereof, then such damage shall be repaired by said lessor as speedily as possible at its own expense; and there shall be such abatement of rent during the period of such deprival of the use of such damaged part of said hotel, as may be mutually agreed upon. And upon failure to so agree upon said abatement, each party shall select an arbitrator and these two arbitrators shall select a third, and the said arbitrators shall consider and determine the amount of said abatement. And the decision of said arbitrators shall be accepted by the parties thereto as final. Any expense involved in said arbitration shall be equally borne by the parties hereto.

XIII. Except as specifically provided in Clause XI and XII hereinabove, the said lessee shall keep the leased premises continuously in good repair at its own expense; and at the expiration of this lease said lessee shall restore said premises to the lessor in as good condition as at the commencement hereof reasonable wear and tear excepted.

XIV. The said lessee shall not sub-lease the said property hereby leased to any other person, firm or corporation, without the written consent of the said lessor. But this Clause shall not be construed to restrict the right of said lessee, which is hereby specifically granted, to sub-lease portions of the said building for purposes not inconsistent with its operation as a hotel as herein provided.

XV. The lessee shall have the right, and hereby assumes the obligation, to alter and reconstruct at its expense the main floor of said hotel so as to provide for additional cafes or dining rooms at the front of said building, and so as to convert the present main dining room into an Assembly Hall. Provided that said alterations shall be in accordance with plans and specifications to be approved by the lessor. And it is understood that this improvement when completed shall belong absolutely to the lessor without any obligation on its part to refund the cost of same to the lessee.

[fol. 35] XVI. As further consideration for the execution hereof R. L. O'Neal, the principal stockholder in said lessee, agrees that he will not during the term of this lease, voluntarily sell, convey or transfer the controlling stock ownership in said lessee to any other person, without the consent of the lessor. And the said R. L. O'Neal executes this contract in his individual capacity as an evidence of said agreement.

In Testimony Whereof, The Lynchburg Hotel Corporation and The Virginian Hotel, Incorporated have cause- this agreement and lease to be signed in duplicate by their respective Presidents; and have caused their corporate seals to be hereunto affixed and attested by their respective Secretaries, the day and date first above written.

The Lynchburg Hotel Corporation, by O. B. Barker, Vice-President. Attest: J. T. Noell, Jr., Secretary. (Seal) The Virginian Hotel, Incorporated, By R. L. O'Neal, President. Attest: F. C. Crider, Secretary. (Seal) R. L. O'Neal.

[Notary acknowledgments omitted in copy.]

[fol. 36] CONSENT TO ASSIGNMENT

The Lynchburg Hotel Corporation does hereby consent to the assignment by The Virginian Hotel, Incorporated, to Albert F. Young and Rosa E. Young, of the lease on the Virginian Hotel property in the city of Lynchburg at the corner of Church and Eighth Streets, dated May 24th, 1923, and to which lease this consent is attached, and does hereby release and discharge The Virginian Hotel, Incorporated, from any liability or obligations as lessee under said lease, from and after the date hereof, and does look to the said Albert F. Young and Rosa E. Young for the performance of all obligations and payments under the said lease. The said Albert F. Young and Rosa E. Young do, by their signatures hereto, expressly assume all obligations and payments under said lease from this date.

In testimony whereof the Lynchburg Hotel Corporation has caused this consent to be hereon endorsed and signed on its behalf this first day of June, 1927, by John W. Craddock, its President, thereunto specifically authorized by its Board of Directors by resolution duly adopted by its Board of Directors at a meeting of said Board held on May 16th, 1927; and the said Albert F. Young and Rosa E. Young, have likewise signed this consent on this 1st day of June, 1927.

Lynchburg Hotel Corporation, By John W. Craddock, President. Attest: J. T. Noell, Jr. Sec'y. (Seal) Rosa E. Young, A. F. Young.

[fol. 37] BEFORE UNITED STATES BOARD OF TAX APPEALS

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 105828

O. H. Tufts, C. P. A. for petitioner.
E. L. Corbin, Esq., for the respondent.

MEMORANDUM OPINION

ARNOLD:

The Commissioner determined deficiencies in income and excess profits taxes for the year 1938 in the amounts of $416.94 and $138.32, respectively. The questions involved are (1) whether petitioner is entitled to restore to its unexhausted base of depreciable assets on December 31, 1937, the amount of $31,400.25 due to a change in rates of depreciation by respondent; and (2) whether petitioner is entitled to a deduction of $70 representing additional capital stock tax paid in 1938. The respondent on brief concedes that petitioner is entitled to the claimed deduction of $70. This deduction will, therefore, be allowed upon recomputation under Rule 50. The facts were stipulated and are included herein by reference.

The petitioner is a Virginia corporation and was incorporated in 1930. It has since January 1, 1931, operated a hotel in Lynchburg, Virginia, as lessee. It filed its income tax return for 1938 with the collector of internal revenue for the District of Virginia at Richmond, Virginia, and reported thereon a net taxable income of $11,688.90.

About 1913 Lynchburg Hotel Corporation cause a hotel known as "The Virginian Hotel" to be erected in Lynchburg, Virginia, which hotel at all times since its completion has been leased to operating individuals and/or corporations. Prior to June 1, 1927, the hotel was operated by Virginia Hotel, Incorporated, under a lease dated May 24, 1923, and expiring January 15, 1939. The hotel was completely furnished and equipped, the furniture and equipment therein being the property of the lessee. On June 1, 1927, with the consent of the owner, lessor, A. F. Young and

R. E. Young, assumed the then existing lease of the hotel and purchased from the lessee all of its furniture and equipment for the sum of $70,899.94. A. F. and R. E. Young operated the hotel under the partnership name of "Virginian Hotel" from June 1, 1927 to December 31, 1930. The partnership was incorporated as the Virginian Hotel Corporation of Lynchburg, the petitioner herein, and all of its issued capital stock, except qualifying shares, was issued to A. F. and R. E. Young for the net book value of the partnership assets. The petitioner has continuously operated the hotel since January 1, 1931, as lessee.

The total amount expended by the partnership and the petitioner for furniture and equipment, including replacements capitalized from June 1, 1927 to December 31, 1938, is as follows:

[fol. 38]

	Furniture and Fixtures	Carpets	Cafe Improvements	Laundry Equipment	Ice Machine	Total
Purchased from prior Lessee June 1, 1927	$38,400.20	$19,341.70	$7,232.40	$4,103.21	$1,822.43	$70,899.94
Additions 1927	$1,730.33	$1,254.90	$9,599.67	$........	$........	$12,584.90
1928	3,087.23	2,745.58	3,894.13	175.00	121.51	10,023.45
1929	692.35	2,395.99	659.08	....	325.00	4,072.42
1930	1,789 54	....	214.81	....	....	1,997.35
1931	15,033.55	4,406.74	3,057.04	1,011.23	241.65	23,750.21
1932	2,733.92	....	242.05	2,447.35	33.68	5,457.00
1933	....	....	....	....	102.96	102.96
1934	999.63	....	49.86	....	....	1,049.49
1935	184.57	814.36	....	....	....	998.93
1936	134.76	686.73	100.00	....	75.00	996.49
1937	544.85	622.54	....	....	....	1,167.39
1938	3,075.76	2,437.79	915.97	....	268.44	6,697.96
Total Additions	$30,006.49	$15,357.63	$18,732.61	$3,633.58	$1,168.24	$68,898.55
Grand Totals	$68,406.69	$34,699.33	$25,965.01	$7,736.79	$2,990.67	$139,798.49

The above does not include the amount of $2,613.67 expended in 1938 for air conditioning equipment, depreciation of which is not at issue herein.

Depreciation was charged and deductions claimed on income tax returns each year since June 1, 1927, at the following straight line rates, allowance having been made for fully depreciated items:

Furniture and Fixtures	10%
Carpets	15%
Cafe improvements	10%
Laundry Equipment	10%
Ice Machine	10%

The respondent did not question the depreciation deduction as claimed each year through the year 1937. In 1938 the petitioner claimed a depreciation deduction based on the above rates amounting to $4,341.97. After an examination of petitioner's income tax return for 1938 the respondent determined that the depreciation claimed was excessive, that the average useful life of the depreciable assets from the time of acquisition in 1927 was as follows, and applied rates accordingly:

Assets	Average Useful Life	Rate
Furniture and Fixtures	20 Years	5%
Carpets	12½ years	8%
Cafe Improvements	20 years	5%
Laundry Equipment	20 "	5%
Ice Machine	20 "	5%

As a result he disallowed $3,046.50 of the amount of depreciation claimed by the petitioner in its return, thus allowing a deduction in the amount of $1,295.47.

[fol. 39] The partnership had a net gain for each of the years from June 1, 1927 to December 31, 1930, inclusive, and the entire amount of depreciation deducted in its returns for those years served to reduce taxable income. The petitioner sustained a net loss for each of the years 1931 to 1936, both inclusive, and the entire amount of depreciation deducted in its returns for those years did not serve to reduce its taxable income. The year 1937 resulted in a net gain and the depreciation deducted on the income tax return for that year served to reduce taxable income. Re-

computing the depreciation for the years prior to 1938, using the amount claimed as a deduction for the years which resulted in a net gain and the amount allowable at the respondent's rates as determined for 1938 for the years which resulted in a net loss, the excess depreciation claimed over the amount allowable is $31,400.25. This amount did not serve to reduce taxable income. Restoring the amount of $31,400.25 to petitioner's unexhausted depreciation base as of December 31, 1937, the correct allowable depreciation for the year 1938, applying respondent's rates, is $4,438.14.

The petition does not question the respondent's determination of the average useful life of the depreciable assets involved nor the rates to be used. It contends that since the petitioner sustained net losses in each of the years 1931 to 1936, both inclusive, and since depreciation claimed in the amount of $31,400.25 in excess of the amount allowable as determined by respondent did not serve to reduce taxable income in such years, that such amount should be restored to its depreciation base as of December 31, 1937.

The Board held in *Kennedy Laundry Company*, 46 B. T. A. 70, following the ruling in *Pittsburgh Brewing Co.* v. *Commissioner*, 107 Fed. (2d) 155, that depreciation is not "allowed" within the meaning of the revenue acts unless it is actually taken as a deduction against taxable income, that to the extent the taxpayer received no tax advantage in certain years prior to the taxable year in which it had sustained net losses, its base for depreciation should be computed by employing the lower rate determined by respondent for such years instead of the rate used by it. This decision is controlling herein. See *Don Lee, Inc.*, v. *United States*, 42 Fed. Supp. 884. The amount of $31,400.25, the excess of depreciation deductions taken in the years 1931 to 1936, inclusive, over the amounts allowable, should be added to the base in computing the depreciation allowable for 1938. The amount so allowable was stipulated to be $4,438.14.

Decision will be entered under Rule 50.

Entered: May 6, 1942.

[fol. 40] BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 105828

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the memorandum opinion of the Board entered May 6, 1942, the petitioner on May 13, 1942 filed a recomputation of tax and on May 25, 1942 the respondent filed a recomputation in agreement with that of petitioner. Now, therefore, it is

Ordered and Decided: That there is an overpayment of income tax for the calendar year 1938 in the amount of $13.47, which amount was paid within three years before the filing of the petition (Sec. 322(d), Revenue Act of 1938); and that there is no deficiency in excess-profits tax for said year 1938.

Enter:

(s) William W. Arnold, Member.

Entered May 28, 1942.

[fol. 41] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

[Title omitted]

PETITION FOR REVIEW—Filed August 18, 1942

Guy T. Helvering, Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Fourth Circuit to review the decision entered May 28, 1942, ordering and deciding that there is an overpayment of income tax for the taxable year 1938 in the amount of $13.47 due Virginian Hotel Corporation of Lynchburg, the respondent on review herein, and that there is no deficiency in excess-profits tax for said year 1938 due by the respondent on review herein. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the United States Internal Revenue Code.

The respondent on review, Virginian Hotel Corporation of Lynchburg, filed its income tax return for the taxable year 1938 with the Collector of Internal Revenue for the District of Virginia, located at Richmond, Virginia, the office of which Collector is within the jurisdiction of the United States Circuit Court of Appeals for the Fourth Circuit, wherein this review is sought.

(Signed) Samuel O. Clark, Jr., Assistant Attorney General; (Signed) J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Of Counsel: Claude R. Marshall, Special Attorney, Bureau of Internal Revenue.

CRM/csl. 8/1942.

[fol. 42] In United States Circuit Court of Appeals for the Fourth Circuit

[Title omitted]

Notice of Filing Petition for Review—Filed August 25, 1942

To: O. H. Tufts, C. P. A., Krise Building, Lynchburg, Virginia.

You are hereby notified that the Commissioner of Internal Revenue did, on the 18th day of August, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fourth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 18th day of August, 1942.

(S.) B. D. Gamble, Clerk, U. S. Board of Tax Appeals.

Service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 24 day of August, 1942.

Agent: (S.) O. H. Tufts, Attorney for Respondent on Review.

CRM/csl. 8/42.

[fol. 43] [File endorsement omitted]

In the United States Circuit Court of Appeals for Fourth Circuit

[Title omitted]

Notice of Filing Petition for Review—Filed August 26, 1942

To: A. F. Young, President of Virginian Hotel Corporation of Lynchburg, Church and Eighth Streets, Lynchburg, Virginia.

You are hereby notified that the Commissioner of Internal Revenue did, on the 18th day of August, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fourth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 18th day of August, 1942.

(Signed) J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 20 day of Aug., 1942. (Sgd.) A. J. Young, Pres., For Respondent on Review.

8/42. CRM/csl.

[fol. 44] [File endorsement omitted]

In United States Circuit Court of Appeals for the Fourth Circuit

[Title omitted]

Statement of Points—Filed September 9, 1942

Now Comes Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of In-

ternal Revenue, and hereby asserts the following errors which he intends to rely on this review:

That the United States Board of Tax Appeals erred:

1. In holding and deciding that taxpayer's base for furniture, fixtures and equipment as of December 31, 1937 should be computed by deducting depreciation for the years 1931 to 1936, both inclusive, at the lower rates determined as reasonable by the Commissioner for the year 1938 instead of at the higher rates used by taxpayer for the years 1931 to 1936, inclusive.

2. In holding and deciding that, to the extent that taxpayer received no tax advantage in the years 1931 to 1936, both inclusive, taxpayer's base for depreciation as of December 31, 1937 should be computed by employing the lower rates for the said years 1931 to 1936, both inclusive, that were determined by the Commissioner as reasonable for the year 1938.

3. In holding and deciding that depreciation is not "allowed" within the meaning of Section 113 (b) (1) (B) of the Revenue Act of 1938, unless it is actually taken as a deduction against taxable income and taxable advantage is obtained thereby.

[fol. 45] 4. In holding and deciding that the aggregate amount of $31,400.25, representing alleged excessive depreciation deductions taken in the years 1931 to 1936, inclusive, should be restored to the cost of taxpayer's depreciable assets as of December 31, 1937 for the purpose of computing depreciation for 1938.

5. In holding and finding that the alleged excessive depreciation in the amount of $31,400.25 for the years 1931 to 1936, inclusive, did not serve to reduce taxable income in said years, there being no substantial evidence to support such a holding and finding.

6. In holding and finding that taxpayer is entitled to a deduction for depreciation in the year 1938 in the amount of $4,438.14.

7. In failing to hold and find that taxpayer is entitled to a deduction for depreciation in the year 1938 only in the amount of $1,295.47.

8. In that its opinion and decision are not supported by its findings of fact and are contrary to the law and the regulations.

9. In ordering and deciding that there is an overpayment in income tax of $13.47 for the year 1938.

10. In ordering and deciding that there is no deficiency in excess-profits tax for the year 1938.

11. In failing to order and decide that there is a deficiency in income tax for the year 1938 due from taxpayer herein in the amount of $416.94.

12. In failing to order and decide that there is a deficiency in excess-profits tax for the year 1938 due from the taxpayer herein in the amount of $138.32.

(Signed) Samuel O. Clark, Jr., Assistant Attorney General; (Signed) J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

CRM/csl. 8/42.

[fol. 46] In United States Circuit Court of Appeals for the Fourth Circuit

[File endorsement omitted]

Designation of Portions of Record, Proceedings and Evidence to Be Contained in Record on Review—Filed Sept. 9, 1942

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Fourth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Fourth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of the proceedings before the Board.

2. Pleadings before the Board:

(a) Petition, including annexed copy of deficiency letter and all exhibits attached.

(b) Answer.

3. Stipulation of Facts.

4. Memorandum opinion of the Board entered on May 6, 1942.

5. Board's decision entered on May 28, 1942.

6. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review.

7. Statement of Points to be relied upon.

[fol. 47] 8. Any and all orders of enlargement of time for the preparation of the evidence and for the transmission and delivery of the record.

9. This Designation.

Said transcript to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Fourth Circuit.

(Signed) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Attorney for Petitioner on Review.

[fol. 48] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 49] In the United States Circuit Court of Appeals for the Fourth Circuit

No. 5004

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner,

versus

Virginian Hotel Corporation of Lynchburg, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

Docket Entries

September 25, 1942. the transcript of record is filed and the cause docketed.

September 29, 1942, the appearance of Frank G. Davidson, Jr., is entered for the respondent.

Same day, the appearance of Samuel O. Clark, Jr., Assistant Attorney General, and Sewall Key, Special Assistant to the Attorney General, is entered for the petitioner.

September 30, 1942, the appearance of J. P. Wenchel, Chief, Counsel, Bureau of Internal Revenue, and Claude R. Marshall, Special Attorney, Bureau of Internal Revenue, is entered for the petitioner.

October 14, 1942, the appearance of L. W. Post, Special Assistant to the Attorney General, is entered for the petitioner.

[fol. 50] Same day, to-wit, October 14, 1942, brief and appendix on behalf of the petitioner are filed.

October 31, 1942, brief on behalf of the respondent is filed.

Argument of Cause

November 17, 1942 (November term, 1942), cause came on to be heard before Parker and Soper, Circuit Judges, and Chesnut, District Judge, and was argued by counsel and submitted.

[fol. 51] In United States Circuit Court of Appeals, Fourth Circuit

No. 5004

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner,

versus

Virginian Hotel Corporation of Lynchburg, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

(Argued November 17, 1942. Decided January 2, 1943)

Before Parker and Soper, Circuit Judges, and Chesnut, District Judge

L. W. Post, Special Assistant to the Attorney General, (Samuel O. Clark, Jr., Assistant Attorney General, and Sewall Key, Special Assistant to the Attorney General, on brief) for Petitioner, and Frank G. Davidson, Jr., for Respondent.

Opinion—Filed January 2, 1943

[fol. 52] Parker, Circuit Judge:

This is a petition to review a decision of the Board of Tax Appeals (now the Tax Court of the United States). The question involved relates to the right of a taxpayer to add to the depreciation base, on a change of the rate of depreciation, amounts charged off and allowed as depreciation in prior years, where no tax benefit has been received as a result of such allowance. The contention of the taxpayer is that the new rate of depreciation should be applied retroactively, and that the excess depreciation charged off and deducted under the old rate should be restored to the base, when it appears that the taxpayer has received no tax benefit from the deduction. The Board sustained this contention and the Commissioner has asked that its decision be reviewed, contending that there is no authority for restoring to the base the depreciation which has been claimed and allowed, and that whether tax benefit has resulted from the allowance or not does not affect the matter.

Taxpayer is a corporation which has operated a hotel in Lynchburg, Va., since January 1, 1931. In making its tax returns from that time through the year 1937, it claimed and was allowed depreciation at straight line rates of 10% on all of its equipment except carpets and upon these at 15%, based upon an estimated useful life of 10 and 6⅔ years respectively. For the year 1938 the taxpayer claimed a deduction for depreciation at the same rates; but the Commissioner determined that the useful life of the equipment had been underestimated and that the rates of depreciation allowed were excessive. The useful life of the equipment except carpets was estimated at 20 years and carpets at 12½ years. From the cost of the property, the depreciation theretofore allowed was deducted, and the remainder was taken as the new base for computing depreciation. The rate was arrived at on the basis of what remained of useful life. Thus on an item of $15,033.55, which had been in service 6½ years, and upon which depreciation [fol. 53] of $9,771.83 had been taken and allowed, the Commissioner found there was a value of $5,261.72 remaining, with a useful life of 13½ years, and allowed annual depreciation of $389.76, or an amount which taken annually for 13½ years would liquidate the remaining value.

The contention of taxpayer is that, instead of doing this, the Commissioner, when putting the new rates of depreciation into effect, should have restored to the base so much of the depreciation shown on its returns for the years 1931 to 1937 as did not reduce its taxable income in those years and was in excess of the amounts of the deductions to which it would have been entitled at the rates of depreciation now determined by the Commissioner to be reasonable. This amount was $31,400.25 and represented the excess of depreciation for the years 1931 to 1936 inclusive, for which the returns of taxpayer showed a net loss. No contention is made with respect to the depreciation for the year 1937, in which the return showed a net gain. It is stipulated that for the years 1931 to 1936 the deduction of depreciation did not serve to reduce the taxable income.

The statute involved is the *Revenue Act* of 1938, 52 Stat. 447. Sec. 23(1) of that statute, under the heading "Depreciation," allows as a deduction from gross income "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." Sec. 23(n) provides that the basis upon which such depreciation shall be allowed is that provided in sec. 114, which is the section that gives the basis for determining the gain upon the sale or other disposition of property. Sec. 114 provides that the basis for determining depreciation shall be the "adjusted basis" of sec. 113(b); and sec. 113(b) provides that proper adjustment shall be made "for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this act or prior income tax laws." It is clear, therefore, that the basis for computing depreciation is that which must be [fol. 54] taken for computing gain upon the sale of the property, and that depreciation theretofore allowed or allowable under the income tax laws must be deducted from the base. The applicable statutes are as follows:

"Sec. 23. Deductions from gross income.

"In computing net income there shall be allowed as deductions:

* * * * * * *

"(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * * * *

"(n) Basis for depreciation and depletion.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * * *

"Sec. 113. Adjusted Basis for determining gain or loss.

* * * * * * *

"(b) Adjusted basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) General rule.—Proper adjustment in respect of the property shall in all cases be made——

* * * * * * *

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * * * *

[fol. 55] "Sec. 114. Basis for depreciation and depletion.

"(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property."

We think that the Board was in error in holding that depreciation claimed and allowed should be deducted from the base in determining gain under sec. 114 only where it has resulted in tax benefit. Depreciation amounts to the sale of property through use; and the intention of Congress is clear that to the extent that depreciation has been allowable under

the law or to the extent that it has been allowed in determining tax liability, it is to be excluded from the value of the property in determining profits from sale or base for allowance of depreciation. There is nothing in the statute, or elsewhere, which justifies restoring to the base the depreciation which has been claimed and allowed in prior returns, merely because such allowance has resulted in no tax benefit (Cf. *Mother Lode Coalition Mines Co.* v. *Helvering*, — U. S. — (decided Dec. 7, 1942); and such restoration is directly in conflict with the statutory provision that adjustment shall be made for depreciation to the extent allowed under the act or prior income tax laws. It is in conflict, too, with the salutary rule that each taxable year must be regarded as an independent unit for income tax purposes. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

It is argued that the word "allowed" as used in the statute means taken as a deduction from income tax paid; but, as pointed out in the dissenting opinion of Member Disney in the case of *Kennedy Laundry Co.* v. *Commissioner*, 46 B. T. A. —, decided January 14, 1942, "In ordinary parlance or thought as to income tax matters the word 'allowed' means in effect 'considered in arriving at the net tax result for the year', and in my opinion that is all that Congress intended in the section here being considered." This is in [fol. 56] accord with our decision in *Helvering* v. *State-Planters Bank & Trust Co.*, 4 Cir. 130 F. 2d 44. The regulation there dealt with provided that the collection of a bad debt should be included in income if the bad debt had previously been "charged off and allowed as a deduction for income tax purposes". We rejected the argument that tax benefit as a result of the deduction was necessary for the inclusion of collections on the debt as income, saying:

"There is nothing in the regulation or in any statute which makes the inclusion in gross income of collections on bad debts, previously charged off as worthless, dependent upon whether or not the charge off has resulted in a tax benefit to the taxpayer. It is argued that the language of the regulation providing for the inclusion of the collection only where the debt has been 'charged off and allowed as a deduction for income tax purposes' has this effect; but manifestly a debt is charged off and allowed as a deduction for income tax purposes when it is claimed and allowed as a deduction in the return of the taxpayer, for the charge off and allowance is made in connection with the return, not

in connection with the payment of the tax." (Italics supplied.)

Prior to the Revenue Act of 1932, provision was made in the Revenue Act of 1926 and subsequent acts for diminution of the base by the amount allowable for depreciation. In the Act of 1932, the provision contained in the 1938 Act was inserted for the first time requiring adjustment for depreciation "to the extent allowed (but not less than the amount allowable)". The purpose of the amendment, as explained in the report of the Senate Committee, was to preclude the possibility of a taxpayer's claiming, on the sale of property, that the depreciation allowed in connection with prior returns was excessive. *S. Rep.* No. 665, 72nd Cong., 1st Sess. p. 29. The Supreme Court had held that the amount allowable for depreciation must be deducted whether taken in prior returns or not (*United States* v. *Ludey,* 274 U. S. 295); and the effect of the amendment was to place depreciation, to the extent that it had been allowed, on the same basis [fol. 57] as allowable depreciation under prior acts. The history and purpose of the amendment are correctly set forth, we think, in the dissenting opinion of Member Disney in the *Kennedy Laundry Company* case, as follows:

"The word 'allowed' was first used in this respect in sec. 202(b), Revenue Act of 1924, where adjustment is required in computing gain or loss from sale or other disposition of property for wear and tear 'previously allowed with respect to such property.' It appears from the committee reports in connection with that statute that in the form the bill had taken in the House the words 'properly chargeable' were used, and on this subject the Senate Committee Report says: 'To remove a possible ambiguity in the House Bill, the deductions are limited to those "previously allowed" rather than those "properly chargeable".' The Revenue Act of 1926, section 202(b), changed the expression to 'allowable', which was by section 113(b)(1)(B) of the Revenue Act of 1932 changed to 'extent allowed (but not less than the amount allowable)'. It seems to me that Congress in 1932, as it did in 1924, used the word 'allowed' in order 'to remove a possible ambiguity', that is, intended in order to make the matter definite, to say that if a depreciation item was 'allowed' in the sense that a claim therefor was not opposed or the depreciation was given effect in determining the tax situation for the year involved, it was to constitute a ground

for adjustment of base for the property considered. I think that was all that Congress had in mind and that the legislators did not go into more tenuous consideration of tax advantage, or lack thereof in the year of depreciation, but laid down a definite and not unfair rule. The taxpayer had the opportunity of preventing the 'allowance' of more depreciation than necessary (above the 'amount allowable' or reasonable amount). He could limit his claim, withdraw it to any extent desired, or oppose its use by the Commissioner. This being within his power, there is no injustice in requiring him, when property basis is considered in later years, to abide by the figure used by him, or permitted by him to be used."

There was no intention to authorize retroactive adjustments. With respect to this, the report of the Senate Committee referred to above had the following to say:

[fol. 58] "Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

It is well settled that allowable depreciation must be deducted from cost in arriving at the base under secs. 114 and 113(b) even though the deduction of depreciation in prior returns has resulted in no tax benefit, and even though depreciation may not have been deducted at all in prior returns. *United States* v. *Ludey, supra; Hardwick Realty Co.* v. *Commissioner*, 2 Cir. 29 F. 2d 498; *Beckridge Corp.* v. *Commissioner*, 2 Cir. 129 F. 2d 318. This is unquestionably a holding that the question of tax benefit is immaterial. As stated above, the effect of the 1932 change in the Revenue Act is to put depreciation allowed in the same category.

In the decision in the *State-Planters Bank & Trust Co. case*, we pointed out the analogy between the situations presented in the case of the collection of a debt previously charged off as worthless and the sale of property at a price in excess of cost less depreciation, and relied upon the Su-

preme Court's decision in *United States* v. *Ludey, supra,* as sustaining our decision that an inquiry as to whether the deduction had resulted in tax benefit was irrelevant. We see no reason to change our conclusion, when the question before us is a question of depreciation. We have carefully considered the decision of the Third Circuit in *Pittsburgh Brewing Co.* v. *Commissioner,* 3 Cir. 107 F. 2d 155; but we regard the authority of that decision as greatly weakened by the Third Circuit's decision in *Commissioner* v. *United States and International Securities Corporation,* 3 Cir. 130 F. 2d 894, which reached the same conclusion that we reached in the *State-Planters Bank & Trust Co. case.*

[fols. 59–60] The method used by the Commissioner for computing depreciation through the remaining years of useful life of the property seems to involve hardship in view of the fact that the taxpayer has received but little tax benefit for the depreciation allowed, and the rates for the remainder of the useful life are less than they would have been if the rates and useful life had been correctly computed in the first instance. The answer is that the remedy is with Congress and not the courts or the executive. Deductions to be allowed from gross income are matters resting in the discretion of Congress; and Congress has expressly provided that the base for computing profits or depreciation must be arrived at by excluding depreciation allowed. The method of spreading the remaining value of the property over the remaining years of useful life is one which has been followed by the Commissioner for many years, and the regulation prescribing it has the effect of law. The pertinent portion of that regulation, Art. 205 of Regulations 77 and 74, is as follows: "The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis."

For the reasons stated, the decision will be reversed and the cause will be remanded for further proceedings not inconsistent herewith.

Reversed.

[fol. 61] In United States Circuit Court of Appeals, Fourth Circuit

No. 5004

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner,

vs.

Virginian Hotel Corporation of Lynchburg, Respondent

On Petition to Review the Decision of The Tax Court of the United States, Formerly the United States Board of Tax Appeals

Judgment—Filed and Entered January 2, 1943

This Cause came on to be heard on the transcript of the record from The Tax Court of the United States, formerly the United States Board of Tax Appeals, and was argued by counsel.

On Consideration Whereof, It is now here ordered and adjudged by this Court that the decision of the said The Tax Court of the United States, formerly Board of Tax Appeals, in this cause, be, and the same is hereby, reversed; and that this cause be, and the same is hereby, remanded to The Tax Court of the United States for further proceedings in accordance with the opinion of the Court filed herein.

John J. Parker, Senior Circuit Judge. Morris A. [fol. 62] Soper, U. S. Circuit Judge. W. Calvin Chesnut, U. S. District Judge.

January 27, 1943, petition of respondent for a stay of the mandate pending application for a writ of certiorari is filed.

In United States Circuit Court of Appeals

Order Staying Mandate—Filed January 29, 1943

Upon the Application of the Respondent, by its counsel, Frank G. Davidson, Jr., Esq., and for good cause shown,

It Is Ordered that the mandate of this Court in the above entitled cause be, and the same is hereby, stayed pending the application of the said Respondent in the Supreme Court

of the United States for a writ of certiorari to this Court, unless otherwise ordered by this or the said Supreme Court, and provided said application is filed in the said Supreme Court within 30 days from this date.

January 28, 1943.

John J. Parker, Senior Circuit Judge.

[fol. 63] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 64] Supreme Court of the United States, October Term, 1942

No. 766

Order Allowing Certiorari—Filed April 5, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

SUBJECT INDEX.

TABLE OF CASES.

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No.....................

VIRGINIAN HOTEL CORPORATION
OF LYNCHBURG,

PETITIONER,

v.

GUY T. HELVERING, COMMISSIONER
OF INTERNAL REVENUE,

RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE FOURTH CIRCUIT

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner prays that a writ of certiorari be issued to review the order of the United States Circuit Court of Appeals for the Fourth Circuit entered January 2, 1943 reversing the order of the United States Board of Tax Appeals (now Tax Court of the United States and hereinafter referred to by that name) entered May 28, 1942.

I.

OPINION BELOW.

The opinion of the United States Circuit Court of Appeals for the Fourth Circuit rendered January 2, 1943 is not yet reported, but is printed as a part of the record (R. 45-52).

II.

BASIS OF JURISDICTION.

Jurisdiction is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. Code Ann. 347.

The opinion of the United States Circuit Court of Appeals for the Fourth Circuit was filed and entered January 2, 1943. Application for stay of mandate pending application in this court for writ of certiorari was filed January 27, 1943. An order staying the mandate for thirty days pending the filing of application for writ of certiorari in this court was entered January 28, 1943 and filed January 29, 1943.

III.

QUESTIONS PRESENTED.

The fundamental question for this court's determination is whether the petitioner in computing its depreciation for the year 1938 under Sections 23(l) and (n), 113(b) (1) (B) and 114(a) of the Revenue Act of 1938, 52 Stat. 494, is entitled to restore to the value of its depreciable assets as of December 31, 1937 so much of the depreciation erroneously reported on its tax returns for the years 1931 to 1937, inclusive, as did not reduce its taxable income in the respective years in which

reported and is in excess of the *allowable* depreciation for said respective years.

The answer to the above question depends upon whether depreciation reported on a tax return, to the extent that it is in excess of the *allowable depreciation* and does not reduce or offset taxable income for the year in which reported, is *allowed* within the meaning of Section 113(b) (1) (B) of the Revenue Act of 1938, 52 Stat. 494, solely because of its having been erroneously reported on the tax return.

IV.

SUMMARY STATEMENT.

The facts in the case were stipulated (R. 22-27). The Tax Court of the United States by reference included the facts as stipulated in its finding of facts (R. 34).

The petitioner is a Virginia corporation which has operated a hotel in Lynchburg, Virginia, since January 1, 1931 (R. 22). It is the owner of the furniture, fixtures and other equipment used in connection with the operation of its hotel business. In each of the calendar years ended December 31, 1931 to December 31, 1937 it depreciated its furniture, fixtures and other equipment at certain straight line rates, namely, ten per centum on all of its furniture, fixtures and other equipment except carpets and fifteen per centum upon its carpets (R. 25). These rates were based upon an estimated useful life of ten years for all of its equipment except carpets and six and two-third years for its carpets. The depreciation so computed was reported on its income tax returns for each of the aforesaid years and no question was raised by the Commissioner as to the rates at which said assets were depreciated (R. 25). On its income tax return filed for the year ended December 31, 1938 the petitioner claimed a deduction for

depreciation in the amount of $4,341.97, said deduction for depreciation being calculated at the same rates at which depreciation had been calculated in the preceding years (R. 22). The Commissioner then for the first time determined that the useful life of the furniture, fixtures and other equipment had been under-estimated and that the rates of depreciation used were excessive. He then determined that the useful life of the furniture, fixtures and other equipment, except carpets, was twenty years from their date of acquisition and the useful life of the carpets twelve and one-half years from their date of acquisition (R. 25, 16-17). The Commissioner then deducted from the costs of the property the depreciation theretofore reported by the petitioner on its income tax returns for prior years and the remaining undepreciated cost was taken as the new base for computing depreciation for the year 1938 and subsequent years. The rate of depreciation was then determined on the basis of what remained of the useful life of the depreciable property. Thus on a certain item the cost of which was $15,033.55 and which had been in use six and one-half years and upon which depreciation of $9,771.83 had been reported on its prior tax returns, the Commissioner found that there was an undepreciated cost of $5,261.72 with a useful life of thirteen and one-half years and allowed annual depreciation of $389.76 or an amount which taken annually for thirteen and one-half years would liquidate the remaining undepreciated cost (R. 25, 16-17).

Petitioner contends that the Commissioner should have restored to the cost of the depreciable assets as of December 31, 1937 so much of the depreciation reported on its tax returns for the years 1931 to 1937, inclusive, as did not reduce its taxable income in those years, and was in excess of the amounts of the depreciation deductions to which it would have been entitled if it had used

the rates of depreciation now determined by the Commissioner to be reasonable. This amount is $81,400.25 and represents so much of the depreciation reported by the petitioner on its tax returns for the years 1931 to 1937, inclusive, as did not reduce its taxable income in the respective years in which reported and is in excess of the allowable depreciation for said years (R. 25-26).

V.

REASONS FOR GRANTING THE PETITION.

1. The United States Circuit Court of Appeals for the Fourth Circuit has decided an important question of Federal law which has not been, but which should be, settled by the Supreme Court of the United States.

2. The United States Circuit Court of Appeals for the Fourth Circuit has rendered an opinion in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue* (C. C. A. 3d), 107 F. (2d) 155. The identical question involved in the instant case, and thus in the case of *Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue, supra,* is now before the United States Circuit Court of Appeals for the Seventh Circuit in the case of *Kennedy Laundry Co.* v. *Commissioner of Internal Revenue*, 46 B. T. A. 70, and also before the United States Circuit Court of Appeals for the Ninth Circuit in the case of *Don Lee, Inc.* v. *United States* (N. D. Cal.), 42 F. Supp. 884.

3. The question presented by this petition involves the proper construction of Sections 23(l) and (n), 113(b) (1)(B) and 114(a) of the Revenue Act of 1938, 52 Stat. 447. Section 23(l) of that statute allows as a deduction from gross income "a reasonable allowance for

the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." Section 23(n) provides that the basis upon which such depreciation shall be allowed is that provided in Section 114, which is the section which gives the basis for determining the gain upon the sale or other disposition of property. Section 114 provides that the basis for determining depreciation shall be the "adjusted basis" of Section 113(b); and Section 113(b)(1)(B) provides that proper adjustment shall be made "for exhaustion, wear and tear, obsolescense, amortization, and depletion, to the extent *allowed* (but not less than the amount *allowable*) under this act or prior income tax laws."

It is clear, therefore, that this court must construe the word *allowed* as used in Section 113(b)(1)(B) of the Revenue Act of 1938. The aforementioned conflicting opinions leave taxpayers in doubt as to the proper construction of the word *allowed* and the determination of this question by this court, will settle the point of law and remove the uncertainty and make for uniformity of decisions as to rights of litigants in tax cases.

WHEREFORE, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit should be granted.

VIRGINIAN HOTEL CORPORATION
OF LYNCHBURG,

By SMELTZER V. KEMP,
FRANK G. DAVIDSON, JR.,
Its Attorneys.

February 20, 1943.

S. V. KEMP,
FRANK G. DAVIDSON, JR.,
303 Law Building,
Lynchburg, Virginia.

SUBJECT INDEX.

TABLE OF CASES.

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No.........................

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG,
PETITIONER,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR PETITIONER.

OPINIONS BELOW.

The opinion of the United States Board of Tax Appeals (now Tax Court of the United States and hereinafter referred to by that name) rendered May 6, 1942 is a memorandum opinion, and thus is not reported. It is included in the record (R. 34-38). The opinion of the United States Circuit Court of Appeals for the Fourth Circuit rendered January 2, 1943 has not yet been reported, but is included in the record (R. 46-52).

BASIS OF JURISDICTION.

Jurisdiction is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. Code Ann. 347.

This case involves income and excess profits taxes for the year 1938 and is taken from the decision of the United States Circuit Court of Appeals for the Fourth Circuit filed January 2, 1943. Application for stay of mandate pending application in this court for writ of certiorari was filed January 27, 1943. An order staying the mandate of said court for thirty days pending the filing of an application for writ of certiorari in this court was entered January 28, 1943 and filed January 29, 1943.

STATEMENT OF CASE.

The facts in this case were stipulated (R. 22-27). The Tax Court of the United States by reference included the facts as stipulated in its finding of facts (R. 34).

The petitioner (hereinafter referred to as the taxpayer) is a Virginia corporation with its principal office in Lynchburg, Virginia. It was incorporated in 1930. Since January 1, 1931 it has operated a hotel in Lynchburg, Virginia. It filed its income tax return for the calendar year 1938 with the Collector of Internal Revenue for the District of Virginia at Richmond, Virginia, and reported thereon a net taxable income of $11,688.90 (R. 22). The taxpayer is the owner of the furniture, fixtures and other equipment used in connection with the operation of its hotel business (R. 23).

On June 1, 1927 A. F. Young and R. E. Young purchased from Virginian Hotel, Inc., the then owner, all of the furniture, fixtures and other equipment used in the operation of said hotel for the sum of $70,899.94. The said A. F. Young and R. E. Young operated the

hotel as partners from June 1, 1927 to December 31, 1930. At that time the partnership was incorporated as the Virginian Hotel Corporation of Lynchburg, the taxpayer herein, and all of its issued capital stock (except qualifying shares) was issued to A. F. Young and R. E. Young for the net book value of the partnership assets. The values of said furniture, fixtures and other equipment remained unchanged after the incorporation since no change in actual ownership was involved. The taxpayer has continuously operated the hotel since January 1, 1931 (R. 23).

The total amount expended by the partnership and the taxpayer for furniture, fixtures and other equipment, including replacements, capitalized from June 1, 1927 to December 31, 1938 is as follows (R. 24):

	Furniture and fixtures	Carpets	Cafe improvements	Laundry equipment	Ice machine	Total
Purchased from prior lessee June 1, 1927	$38,400.20	$19,341.70	$7,232.40	$4,103.21	$1,822.43	$70,899.94
Additions:						
1927	1,730.33	1,254.90	9,599.67			12,584.90
1928	3,087.23	2,745.58	3,894.13	175.00	121.51	10,023.45
1929	692.35	2,395.99	659.08		325.00	4,072.42
1930	1,789.54		214.81			1,997.35
1931	15,035.55	4,406.74	3,057.04	1,011.23	241.65	23,750.21
1932	2,733.92		242.05	2,447.35	33.68	5,457.00
1933					102.96	102.96
1934	999.63		49.86			1,049.49
1935	184.57	814.36				998.93
1936	134.76	686.73	100.00		75.00	996.49
1937	544.85	622.54				1,167.39
1938	3,075.76	2,437.79	915.97		268.44	6,697.96
Total	30,006.49	15,357.63	18,732.61	3,633.58	1,168.24	68,898.55
Grand total	68,406.69	34,699.33	25,965.01	7,736.79	2,990.67	139,798.49

In each of the calendar years ended December 31, 1931 to December 31, 1937 the taxpayer depreciated its furniture, fixtures and other equipment at certain

straight line rates, namely, ten per centum on all of its furniture, fixtures and other equipment, except carpets, and fifteen per centum on its carpets (R. 25). These rates were based upon an estimated useful life of ten years for all of its equipment, except carpets, and six and two-thirds years for its carpets. The depreciation so computed was reported on its income tax returns for each of the aforesaid calendar years and no question was raised by the Commissioner as to the rates at which said assets were depreciated (R. 25).

On its income tax return filed for the calendar year ended December 31, 1938 the taxpayer claimed a deduction for depreciation in the amount of \$4.341.97, said depreciation being calculated at the same rates at which depreciation had been calculated in the preceding years (R. 22). The Commissioner then for the first time questioned the amount of the deduction for depreciation and determined that the useful life of the furniture, fixtures and other equipment had been under-estimated and that the rates of depreciation therefore used by the taxpayer were excessive. He then determined that the useful life of the furniture, fixtures and other equipment, except carpets, was twenty years from their date of acquisition and the useful life of the carpets twelve and one-half years from their date of acquisition (R. 25, 16-17). Accordingly he disallowed \$3,046.50 of the amount of depreciation claimed by the taxpayer in its return for the year 1938 and allowed a deduction in the amount of \$1,295.47 (R. 25). The Commissioner calculated the depreciation by deducting from the cost of the property to the taxpayer the depreciation theretofore reported by it on its income tax returns for prior years and the remainder was taken as the new basis for computing depreciation for the year 1938 and subsequent years. The rate of depreciation was then determined on the basis of what remained of the useful life

of the depreciable property. Thus on a certain item the cost of which was $15,033.55 and which had been in use six and one-half years and upon which depreciation of $9,771.83 had been reported on its prior tax returns, the Commissioner found that there was an undepreciated cost of $5,261.72 with a useful life of thirteen and one-half years and allowed annual depreciation of $389.76 or an amount, which if taken annually for thirteen and one-half years would liquidate the remaining undepreciated costs (R. 25, 16-17).

The partnership had a net gain for each of the years from June 1, 1927 to December 31, 1930, inclusive, and the entire amount of depreciation reported in its returns for those years served to reduce taxable income. The taxpayer sustained a net loss for each of the years 1931 to 1936, both inclusive, and the entire amount of depreciation reported in its returns for those years did not serve to reduce its taxable income. The year 1937 resulted in a net gain and the depreciation reported on the income tax return for that year served to reduce taxable income. Recomputing the depreciation for the years prior to 1938, using the amount reported as a deduction for the years in which the taxpayer reported a net profit, and the amount *allowable,* at the Commissioner's rates as determined for 1938, for the years which resulted in a net loss, the excess depreciation reported by the taxpayer over the amount *allowable* is $31,400.25. This amount did not serve to reduce taxable income. Restoring the amount of $31,400.25 to taxpayer's unexhausted depreciation base as of December 31, 1937, the correct allowable depreciation for the year 1938 applying the Commissioner's rates, is $4,438.14 (R. 25-26). The Tax Court of the United States decided that the taxpayer was entitled to restore to its unexhausted depreciation base as of December 31, 1937 the sum of

$81,400.25. On appeal to the United States Circuit court of Appeals for the Fourth Circuit the decision of the Tax Court was reversed.

ASSIGNED ERRORS.

The essential error of the United States Circuit Court of Appeals for the Fourth Circuit is its holding that the taxpayer is not entitled to restore to the value of its depreciable assets as of December 31, 1937 so much of the depreciation erroneously reported on its tax returns for the years 1931 to 1937, inclusive, as did not reduce its taxable income in the respective years in which reported and is in excess of the allowable depreciation for said respective years. This amount is $31,400.25.

This error arises as a result of the United States Circuit Court of Appeals for the Fourth Circuit holding that depreciation reported on a tax return, even though such depreciation is in excess of the allowable depreciation and does not reduce or offset taxable income for the year in which reported, is allowed within the meaning of Section 113(b)(1)(B) of the Revenue Act of 1938, 52 Stat. 494, solely because of its having been erroneously reported on the tax return.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1938, c. 289, 52 Stat. 447:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"* * * * *

"(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in

the trade or business, including a reasonable allowance for obsolescense. * * *

"* * * * *

"(n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

"* * * * *

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"* * * * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"* * * * *

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescense, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

"* * * * *

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(a) *Basis for depreciation.* — The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

"* * * * *"

The applicable regulations are Articles 23(1)-1, 2, 4, 5 and 9, 113(b)-1 and 114-1 of Treasury Regulations 101, relating to the Revenue Act of 1938.

SUMMARY OF ARGUMENT.

The decision of the United States Circuit Court of Appeals for the Fourth Circuit is unsound. Sections 114(a) and 113(b)(1)(B) of the Revenue Act of 1938 provide that in determining the basis for depreciation proper adjustment shall be made in respect of prior years for depreciation, to the extent *allowed* (but not less than the amount *allowable*) under the Act or prior income tax laws. The decision of the United Circuit Court of Appeals requires the taxpayer to adjust the basis of its depreciable assets not only for the *allowable* depreciation in the prior years, but also for all depreciation reported by it on its tax returns in such prior years even though such reported depreciation is in excess of the *allowable* depreciation and did not off-set or reduce the taxable income of the taxpayer in the years in which reported. This inequitable result was clearly not intended by Congress when it amended Section 113(b)(1)(B) of the Revenue Act of 1932, which provision of the Revenue Act of 1932 is identical with Section 113(b)(1)(B) of the Revenue Act of 1938 and here under consideration.

ARGUMENT.

Proper Construction of the Word "Allowed"

The taxpayer, *in limine*, wishes to call the court's attention to the fact that it depreciated its furniture, fixtures and other equipment for the years 1931 to 1937, inclusive, at certain fixed rates. The depreciation so computed was reported by it as a deduction on each of its income tax returns for the years 1931 to 1937, inclusive, and the amount of depreciation reported as a deduction on said returns was not questioned by the Commissioner. In the year 1938 the taxpayer again depreciated its assets by using the same percentages which it had

used in the preceding mentioned years. The Commissioner of Internal Revenue then for the first time questioned the reasonableness of the rates used by the taxpayer and accordingly determined that the useful life of the taxpayer's depreciable assets had been under-estimated and that the rates used by the taxpayer in computing its depreciation were excessive. He then determined that the useful life of taxpayer's furniture, fixtures and other equipment except carpets was twenty years and the useful life of the carpets twelve and one-half years. From the cost of the said furniture, fixtures and other equipment the depreciation theretofore reported by the taxpayer on its returns was deducted, and the remainder was taken as the new base for computing depreciation. The rate of depreciation was arrived at on the basis of what remained of useful life.

As a result of the Commissioner's actions the taxpayer's allowable depreciation for the year 1938 was reduced from $4,341.97 to $1,295.47. As this action was taken by the Commissioner it can hardly be argued that the taxpayer is not equitably entitled to restore to the value of its depreciable assets as of December 31, 1937 so much of the depreciation reported by it on its income tax returns for the years 1931 to 1937 as did not reduce its taxable income in the respective years in which reported and is in excess of the depreciation which would have been reported by the taxpayer on said returns if it had depreciated its assets according to the rates now determined by the Commissioner as to be reasonable.

The question presented arises under the Revenue Act of 1938, 52 Stat. 447. Section 23(n) of that Act provides that the basis upon which depreciation is to be allowed shall be as provided in Section 114. Section 114(a) of the Act then provides that the basis for depreciation shall be the adjusted basis of said property provided in Section 113(b) for the purpose of determin-

ing the gain upon the sale or other disposition of such property. Section 113(b)(1)(B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913 for depreciation to the extent *allowed* (but not less than the amount *allowable*) under the Act or prior income tax laws.

The taxpayer contends that depreciation is not *allowed* within the meaning of the statute when it is reported by it on an income tax return, but is not used as a deduction on said return because the taxpayer has no net income which is offset thereby. *Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue* (C. C. A. 3d), 107 F. (2d) 155; *Don Lee, Inc.* v. *United States* (N. D. Cal.), 42 F. Supp. 884; *Kennedy Laundry Co.* v. *Commissioner of Internal Revenue,* 46 B. T. A. 70.

Prior to the Revenue Act of 1924 there was no specific provision with respect to adjustment for depreciation in computing gain or loss from a sale of property. In spite of this fact the courts held that when property is sold the basis thereof must be reduced by the aggregate amount of depreciation which was legally *allowable* in past years. *United States* v. *Ludey,* 274 U. S. 295, 71 L. Ed. 1054; *Hardwick Realty Co.* v. *Commissioner* (C. C. A. 2d), 29 F. (2d) 498. Neither of these two cases decide the precise question here involved. An examination of the case of *United States* v. *Ludey, supra,* discloses, however, that Mr. Justice Brandeis in his opinion at page 304 expressly repudiated the principle here contended for by the respondent when he said:

> " * * * On the other hand, we cannot accept the government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless in-

tended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

By Section 202(b) of the Revenue Act of 1924 it was provided that in computing gain or loss, adjustment should be made for depreciation previously *allowed.* The word *allowed* as used in this section of the Revenue Act of 1924 seems never to have been judicially construed. Section 202(b) of the Revenue Act of 1926 is different in that it provides for diminution of the basis by the amount of the deductions for depreciation which have since the acquisition of the property been *allowable.* That provision is also contained in Section 111(b)(2) of the Revenue Act of 1928. In Section 113(b)(1)(B) of the Revenue Act of 1932 the law was again changed so as to provide for adjustment for depreciation to the extent *allowed* (but not less than the amount *allowable*) under that Act or prior income tax laws. That same provision is contained in all subsequent Revenue Acts, including the statute here involved (Section 113(b)(1)(B) of the Revenue Act of 1938, supra). It is thus clear that this court has only to determine why Congress used the word *allowed* in Section 113(b)(1)(B) of the Revenue Act of 1932 and then construe said section so as to carry out the purpose and intent of Congress. This court in the recent case of ***Harrison* v. *Northern Trust Co. et al.,*** decided January 11, 1943, 87 L. Ed. 320, 322, quite pointedly said, "But words are inexact tools at best and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how 'clear the words may appear on "superficial examination"' * * * ." An examination of the legislative history of Section 113(b)(1)(B) discloses the reason for the 1932 amendment and thus makes it unnecessary for this court to speculate as to the reason for the amend-

ment. The Senate Report on the Bill states that not infrequently a taxpayer who had *taken* and been *allowed* depreciation deductions at certain rates consistently over a period of years would later, when he found it to his advantage so to do, claim that the allowances so made to him were excessive and that the amounts which were in fact *allowable* were much less. Not infrequently the taxpayer would not make such a contention until the government would be barred from collecting the additional taxes which would be due for the prior years if the taxpayer's contentions were upheld. While Congress was of the opinion that the law then in force did not countenance any such inequitable results, it was of the opinion that the new law should preclude any such possibility.[1] The Senate Report leaves no doubt but that the amendment was to apply only to those cases in which a deduction for depreciation has been both *taken* and *allowed,* that is, the deduction must be taken on the return and it must also offset or reduce taxable income. The construction of the law here contended for by the taxpayer also carries out the declared purpose of Congress to prevent a taxpayer, who has had the *benefit* of a larger depreciation deduction from gross income than was properly *allowable* to him, from claiming upon the sale of the depreciated property that his sales basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. No such double deduction can be obtained by the taxpayer in this case as

[1]See S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum Bull. (Part 2) 496, 517), as follows:

"In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made 'to the extent allowed (but not less than the amount allowable)' instead of 'by the amount * * * allowable' as in the prior act. The Treasury has frequently encountered cases where a tax-

the stipulated facts show that the taxpayer sustained a net loss for each of the years 1931 to 1936, inclusive, and the entire amount of depreciation deducted on its income tax returns for those years did not serve to reduce its taxable income.

The United States Circuit Court of Appeals for the Third Circuit in the case of ***Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue, supra,*** after a careful consideration of the legislative history of Section 113(b)(1)(B) of the Revenue Act of 1932, decided that depreciation is not *allowed* under the statute unless it offsets or reduces taxable income. The court in delivering its opinion in this case at page 156, said:

> "* * * After full consideration of this question we have reached the conclusion that depreciation is not 'allowed' *within the meaning of the Act unless it is actually taken as a deduction against taxable income.*
>
> "Allow is defined as 'To grant (something) as a deduction or an addition; esp., to abate or deduct; as, to allow a sum for leakage.' Webster's New International Dictionary, 2d Ed., p. 70, def. 5. 'Allowed' in the statute accordingly means granted as a deduction. Deduction is defined as 'that which is deducted; the part taken away; abatement; as a deduction from the yearly rent.' Webster's New International Dictionary, 2d Ed., p. 284, def. 2b. It is the subtrahend in the process of subtraction. Obviously a minuend is necessary to the process. In the case before us the subtrahend is the depreciation

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payer, who *has taken* and *been allowed* depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment

and the minuend is the taxable income. If the minuend income is absent it follows that there can be no deduction and consequently no allowance within the meaning of the Act.

"The legislative history of the provisions of the Revenue Act of 1932 under consideration supports our view that the word 'allowed' in the Act refers only to depreciation which has been availed of by the taxpayer as an offset to taxable income. In the report of the Committee on Ways and Means of the House of Representatives (House Rep. 708, 72nd Cong., 1st sess., p. 22) upon the portion of the Act now under consideration appears the following (italics ours):

" 'In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of 'by the amount * * * allowable' as in the prior Act. The treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The treasury is obliged to rely very largely upon the good faith and judgment of

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of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayers, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. * * *"

the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.'

"Obviously the committee referred to the situation in which a taxpayer, having had the benefit of a larger depreciation deduction from gross income than was properly allowable to him, claims upon the sale of the depreciated property that his sale basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. We think it clear that it was to prevent the possibility of such a double deduction that the provisions of the Revenue Act of 1932 which we are considering were enacted. No double benefit can be received where, as in the case before us, the depreciation originally claimed offset no income which would otherwise have been taxable."

Does the Construction of the Word "Allowed" Here Contended for by the Taxpayer Conform to the Theory of Depreciation?

The depreciation charge permitted as a deduction from gross income in determining the taxable income of a taxpayer for any year represents the reduction during the year of the capital assets through wear and tear. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year in order that at the end of the useful life of such assets the aggregate of the sums set aside (with the salvage value) equals the original cost. The theory underlying this

allowance for depreciation is that by using up the depreciable assets a gradual sale is made of them. The depreciation charge in any year is the measure of the cost of the part which has been used up in that year. When the assets are disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of the property. See *United States* v. *Ludey, supra.* The application of this theory of depreciation compels a taxpayer to deduct each year from the value of his depreciable property an amount equal to the value of the property actually used up during the year. Thus if a taxpayer has purchased depreciable property at a cost of $100,000.00, the useful life of which property is ten years, he must each year take as a deduction for depreciation $10,000.00. This amount is usually referred to as the *allowable* depreciation and must be deducted each year by the taxpayer regardless as to whether he has taxable income. *Beckridge Corporation* v. *Commissioner of Internal Revenue* (C. C. A. 2d), 129 F. (2d) 318; *Hardwick Realty Co.* v. *Commissioner of Internal Revenue* (C. C. A. 2d), 29 F. (2d) 498. The reason for this equitable and salutary rule is that since the taxpayer each year uses up a portion of the value of his depreciable assets, his income for such year can only be accurately determined if he deducts from his gross income for such year his allowable depreciation. Any other rule would not correctly reflect the taxpayer's income for such year.

The Commissioner of Internal Revenue in this case has consistently urged that this theory of depreciation requires the taxpayer to reduce the basis of its depreciable assets as of December 31, 1937 by not only the *allowable* depreciation for all previous years, but by the

entire amount of depreciation reported by the taxpayer on its income tax returns for such previous years, regardless as to whether such reported depreciation reduced or offset its income in the year in which reported. Obviously the result contended for by the Commissioner does not give effect to the theory of depreciation, but is in direct conflict therewith as it requires the taxpayer to take a smaller deduction for depreciation in one year than another when actually the same use has been made of the depreciable assets each year. If the theory of depreciation is to be given full effect, the taxpayer should be allowed to deduct for depreciation the same amount each year, provided, of course, the use made of the depreciable property is the same each year. It seems clear that it was the purpose of Congress in amending Section 113(b)(1)(B) of the Revenue Act of 1932, supra, to depart from this theory of depreciation only when it is necessary so to do in order to prevent a taxpayer from obtaining a double deduction. Since no double deduction can be obtained in this case the theory of depreciation should be given effect by allowing the taxpayer in the year 1938 to take as a deduction for depreciation an amount equal to the measure of the cost of the depreciable property used up during the year.

The Tax Benefit Rule.

The taxpayer also believes that it is entitled to restore to the value of its depreciable assets as of December 31, 1937 the sum of $31,400.25 under "The Tax Benefit Rule." This Rule stated generally is that where an amount has been deducted by a taxpayer on his return in a prior year and such deduction when taken did not offset taxable income, then no tax benefit arises from the deduction and thus the recovery in a later year of the amount deducted should not be treated as taxable income. This rule has frequently been applied by the courts

which hold that where amounts previously deducted from income for losses, expenses, bad debts and taxes did not effect an offset of taxable income for the year in which deducted, then the recovery of such amounts in subsequent years does not have to be included in gross income in the year of recovery. *Central Loan & Investment Co.* v. *Commissioner of Internal Revenue,* 39 B. T. A. 981; *National Bank of Commerce of Seattle* v. *Commissioner of Internal Revenue,* 115 F. (2d) 875; *Amsco Wire Products Corporation, Transferee,* v. *Commissioner of Internal Revenue,* 44 B. T. A. 717; *American Dental Co.* v. *Commissioner of Internal Revenue,* 44 B. T. A. 425; *Shell Milling Co.* v. *Commissioner of Internal Revenue,* Memo. B. T. A. Docket No. 101415. While the tax benefit rule has received wide approval by the courts, it has not been universally followed. *Helvering* v. *State Planters Bank & Trust Co.* (C. C. A. 4th), 130 F. (2d) 44; *Commissioner of Internal Revenue* v. *United States and International Securities Corporation* (C. C. A. 3d), 130 F. (2d) 894. It is interesting to note, however, that the tax benefit rule now has the sanction of Congress as Section 116 of the Revenue Act of 1942, (which section also amends every prior revenue act) expressly provides for the exclusion of such recoveries from gross income. This section of the Revenue Act of 1942 thus constitutes a legislative reversal of the decisions in the cases of the *State Planters Bank & Trust Company* and *United States and International Securities Corporation.*

Cases Relied Upon by the Respondent in the Lower Courts.

The taxpayer has hereinbefore considered the cases of *United States* v. *Ludey, supra,* and *Hardwick Realty Co.* v. *Commissioner, supra.* The facts in these two cases are very similar to the facts in the case of *Beckridge*

Corporation v. *Commissioner of Internal Revenue* (C. C. A. 2d), 129 F. (2d) 318, and thus all three of these cases will be considered together. These cases hold that upon a sale of property the basis thereof must be reduced by the amount of depreciation which was legally allowable in past years even though no such deduction was claimed on the prior tax returns and no tax advantage would have resulted if it had been so claimed. These cases, it is submitted, are correctly decided and are in accord with the theory of depreciation urged by the taxpayer in this case.

The Commissioner of Internal Revenue in the lower courts has urged that the cases of *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 75 L. Ed. 383, and *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 75 L. Ed. 1049, are authority for the proposition that each taxable year must be regarded as an independent unit for income tax purposes. These cases are undoubtedly authority for such proposition. The respondent argues that it is contrary to the spirit of this rule to permit the taxpayer to take a proper deduction for depreciation in the year 1938 because it erroneously reported its depreciation in prior years. It is submitted, however, that the rule that each taxable year must be considered as an independent unit for income tax purposes is not effected by refusing to permit the taxpayer in this case to take as a deduction the depreciation which it actually sustained in the taxable year because in prior years it mistakenly claimed deductions for depreciation in excess of the amounts properly allowable. The proposition here contended for seems to have been approved by this court in the case of *Koshland* v. *Helvering*, 298 U. S. 441, 80 L. Ed. 1268. In that case it was decided that a taxpayer upon a sale or other disposition of his property is entitled to use the correct basis thereof in determining his gain or loss

regardless of how the property may have been treated in prior years.

The cases of *Helvering* v. *State Planters Bank & Trust Co.* (C. C. A. 4th), 180 F. (2d) 44, and *Commissioner of Internal Revenue* v. *United States and International Securities Corp.* (C. C. A. 3d), 180 F. (2d) 894, both deal with the question whether a taxpayer must include in his gross income collections on bad debts previously charged off as worthless when the charge-off did not result in a tax benefit to the taxpayer. These cases were cited and relied upon by the United States Circuit Court of Appeals for the Fourth Circuit in reaching its decision in this case. In view of the fact that Section 116 of the Revenue Act of 1942 constitutes a legislative reversal of the decisions in these cases, it seems unnecessary to discuss such cases further.

CONCLUSION.

The taxpayer submits that the United States Circuit Court of Appeals for the Fourth Circuit was clearly in error in deciding that it is not entitled to restore to the value of its depreciable assets as of December 31, 1937 the sum of $31,400.25 and that, therefore, the judgment of that court should be reversed.

Respectfully submitted,

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG.

By S. V. KEMP AND
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303 Law Building,
Lynchburg, Virginia.

February 22, 1943.

FILE COPY

No. 766

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG,
Petitioner

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR PETITIONER

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INDEX

CASES CITED

Statutes

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BRIEF FOR PETITIONER

Opinions Below

The opinion of the United States Board of Tax Appeals (now Tax Court of the United States), being a memorandum opinion, is not officially reported but is printed in the record (R. 34). The opinion of the United States Circuit Court of Appeals for the Fourth Circuit is reported in 132 F. (2d) 909 (R. 46).

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on January 2, 1943 (R. 53). The petition for certiorari was filed in this Court on February 25, 1943, and

certiorari was granted on April 5, 1943 (87 L. ed. adv. ops. 778). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938).

Question Presented

The sole question presented by this writ is whether petitioner, in determining the adjusted basis of its depreciable assets at December 31, 1937 upon which to compute its depreciation for the calendar year 1938, is required to subtract from the cost of such depreciable assets the amount by which the depreciation reported on its tax returns for the years 1931 to 1936 inclusive exceeded the depreciation properly allowable in those years, where petitioner sustained in each such year a net loss greater than such excess.

Statute Involved

The statute involved is the Revenue Act of 1938 (52 Stat. 447), Sections 23 (l) and 23(n), 113(b)(1)(B) and 114(a). These sections provide as follows:

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * *

(n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear,

and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * *

Sec. 113. Adjusted Basis for Determining Gain or Loss.

* * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * *

Sec. 114. Basis for Depreciation and Depletion.

(a) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * *"

Statement

Petitioner, a Virginia corporation, from January 1, 1931, and its predecessor partnership from June 1, 1927 to December 31, 1930, operated a hotel in Lynchburg, Vir-

ginia (R. 23). The cost of its depreciable assets and the additions thereto are tabulated in the Record (R. 24). From June 1, 1927 through 1938 depreciation on such assets was reported by petitioner and the predecessor partnership on the returns on a straight line basis at a rate of 15% on carpets and 10% on all other equipment, which would have exhausted the properties in 6⅔ and 10 years, respectively (R. 25). This depreciation was excessive. The amounts properly allowable in those years was 8% on carpets and 5% on all other equipment based upon useful lives of 12½ and 20 years, respectively[1] (R. 25, 26). There was a profit for each of the years 1927 to 1930, inclusive, and for the year 1937; and the entire depreciation reported in each such profit year served to reduce taxable income. Petitioner sustained a loss in each year from 1931 to 1936 inclusive even if only the amounts of depreciation properly allowable in each such year had been deducted, so that the excessive depreciation reported on each such return did not reduce taxable income (R. 25).

The difference between the depreciation reported on the returns in said loss years and the depreciation properly allowable in such years is $31,400.25 (R. 26). In auditing petitioner's return for 1938 respondent adjusted the basis of petitioner's property by subtracting from the cost thereof, not only the depreciation properly allowable in such loss years, but also the amount of $31,400.25 in excess of that properly allowable in such loss years, and asserted a deficiency in tax resulting from such action (R. 14, 15, 25). Petitioner claims that the depreciation in excess of that "allowable" for each such loss year should not be subtracted from the cost of its properties in determining the adjusted basis thereof at December 31, 1937. Petitioner admits of course that the depreciation properly allowable

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[1] For brevity we hereafter refer only to the items which had a 20 year life. The principle involved is of course exactly the same for the shorter lived property.

in each of such years is deductible, even though it did not reduce taxable income.[2]

The issue was tried before the Board on a stipulation of facts which are summarized above. On May 6, 1942 the Board filed its memorandum opinion holding in favor of petitioner and stating (R. 38):

> "The amount of $31,400.25, the excess of depreciation deductions taken in the years 1931 to 1936, inclusive, over the amounts allowable, should be added to the base [in other words, not subtracted from the cost] in computing the depreciation allowable for 1938."

On May 28, 1942 the Board entered its decision determining that petitioner overpaid its tax for 1938 in the sum

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[2] The method employed in computing depreciation for 1938 upon petitioner's property, and the difference between the petitioner's and respondent's computations, may be made clear by a simple example. For instance, take additions to furniture and fixtures purchased in 1931 (R. 16, 19):

Petitioner's Computation		*Respondent's Computation*	
1. Cost of 1931 Additions.	$15,033.55	1. Cost of 1931 Additions	$15,033.55
2. Depreciation allowable (5%) for 1931-1936 and depreciation allowed (10%) for 1937........	5,918.57	2. Depreciation reported in petitioner's returns 1931-1937	9,771.83
3. Adjusted basis at beginning of 1938 (1-2).....	$ 9,114.98	3. Adjusted basis at beginning of 1938 (1-2)..	$ 5,261.72
4. Depreciation for 1938—adjusted basis divided by remaining life (13½ years)	675.18	4. Depreciation for 1938—adjusted basis divided by remaining life (13½ years)	389.76

It is to be noted that the only point at which petitioner and respondent differ in applying this method is with respect to item 2, the amount of depreciation to be deducted from cost in arriving at the adjusted basis at the end of 1937. Petitioner subtracts only the amount of depreciation properly "allowable" in the loss years. Respondent subtracts the amounts reported on petitioner's returns for such years, even though the excess over the amount allowable in each of the loss years was not a proper deduction in those years *and* did not reduce petitioner's taxable income.

of $13.47 (R. 39). This decision was reversed by the Circuit Court of Appeals, and that Court's decision is now here for review upon writ of certiorari (R. 53).

Specification of Errors to Be Urged

The Court below erred in holding:

1. That petitioner in computing the adjusted basis of its depreciable assets as of December 31, 1937 is required to subtract not only the depreciation "allowable" in prior years but also the depreciation reported on its returns in excess of that legally "allowable" and which did not reduce taxable income.

2. That the excessive depreciation reported in petitioner's returns for the years 1931 to 1936 inclusive has been "allowed" within the meaning of Section 113(b)(1)(B) of the Revenue Act of 1938, although it did not serve to reduce taxable income.

Summary of Argument

Section 113(b)(1)(B) of the Revenue Act of 1938, which requires that in determining the unexhausted basis of depreciable property adjustment be made for depreciation "to the extent allowed (but not less than that allowable)", does not require that there be subtracted from the cost of property depreciation in excess of that properly "allowable" in prior years where such excessive depreciation was reported on the taxpayer's returns for such prior years but did not reduce taxable income. Such excessive depreciation in loss years was not "allowed" within the meaning of the subsection.

It is clear from the legislative history of subsection (B), which was amended to its present form in 1932, that the

word "allowed" was added for the sole and declared purpose of requiring the reduction of basis by the amount of depreciation deducted on returns in excess of that "allowable" where, and only where, such excess resulted in reducing income and the government would be barred from collecting the taxes due for the prior years.

The ordinary usage of the word "allowed" embraces much more than the mere reporting of an item on a return.

Congress and the Commissioner have had a uniform policy of not seeking to bind a taxpayer by errors in prior years and of not perpetuating those errors in later years, except in those situations where a change in position will result in unfairly depriving the government of taxes to which it is entitled. Section 113(b)(1)(B), as petitioner construes it, clearly conforms with this policy; upon respondent's construction it is clearly out of harmony with this policy.

Petitioner's interpretation is confirmed by the fact that Congress, in enacting the Revenue Act of 1942 (56 Stat. 812), amended Section 113(b)(1) in a number of respects but did not change one word of subsection (B) involved herein—notwithstanding the fact that at that time four cases had been decided by various courts construing the word "allowed" as petitioner construes it, and that at that time no case had been decided which adopted respondent's construction.

The construction of the word "allowed" advanced by respondent would concededly be inequitable and work a hardship upon taxpayers, as the Court below specifically pointed out in its opinion herein. The construction advanced by the petitioner is fair and cannot under any circumstance work a hardship on the government.

ARGUMENT

WHERE DEPRECIATION IN EXCESS OF THAT ALLOWABLE IS REPORTED ON A RETURN FOR A LOSS YEAR AND DOES NOT OFFSET TAXABLE INCOME THE EXCESS IS NOT SUBTRACTED FROM COST IN DETERMINING THE ADJUSTED BASIS OF THE PROPERTY IN QUESTION.

The Revenue Act of 1938, Section 23 (l) provides for a deduction of a reasonable allowance for exhaustion, wear and tear of property used in business. Section 23 (n) provides that the basis upon which exhaustion, wear and tear are to be allowed shall be as provided in Section 114, which in turn provides that the basis is to be adjusted on account of depeciation in accordance with the provision of subsection (B) of Section 113(b)(1) as follows:

> "(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

The sole issue in this case is whether or not depreciation in the amount of $31,400.25 reported on petitioner's returns in its loss years from 1931 to 1936 which was in excess of that "allowable" for such years *and* which did not reduce taxable income was "allowed" within the meaning of the subsection quoted above. The decision of this case turns upon the meaning of the word "allowed" in that subsection.

Respondent contends that depreciation is "allowed" within the meaning of the statute quoted, if it is reported by a taxpayer on his return and not objected to by the Commissioner, even though it admittedly exceeds the amount "allowable" and also does not reduce taxable income. Petitioner contends, on the contrary, that such excessive depreciation is "allowed" within the meaning of

the statute only if it offsets taxable income and thus reduces the taxes which otherwise would have been payable.[3]

1. Distinction between the words "allowed" and "allowable" in Section 113(b)(1)(B).

Experience before the Court below and before the Bureau of Internal Revenue suggests that before entering into an analysis of the meaning of the word "allowed" there should be brought clearly into focus two vital facts which must be kept fully in mind.

First, petitioner has conceded throughout, and there is no issue whatsoever in this case on the proposition, that the depreciation properly "allowable" in any year is a deduction for that year and reduces the basis of the property, whether or not the taxpayer had income in that year—a point which has been long since decided. *U. S.* v. *Ludey,* 274 U. S. 295; *Hardwick Realty Co.* v. *Commissioner,* 29 F. (2d) 498 (C. C. A. 2d); *Beckridge Corp.* v. *Commissioner,* 129 F. (2d) 318 (C. C. A. 2d). The sole issue here is with reference only to that portion of depreciation reported on a return in a loss year *which exceeds the amount of depreciation properly "allowable".*

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[3] Although the meaning of the word "allowed" is the sole issue involved, the Circuit Court of Appeals states in the second sentence of its opinion (R. 46):

> "The question involved relates to the right of a taxpayer to add to the depreciation base, on a change of the rate of depreciation, amounts charged off *and allowed* as depreciation in prior years, where no tax benefit has been received as result of such allowance." (Emphasis supplied.)

The Court below could not reasonably have been expected correctly to analyze the problem when it began the opinion with the *assumption* that the excessive depreciation which did not reduce taxable income *was "allowed".* That is the sole issue to be determined. If the excess depreciation was "allowed" within the meaning of the subsection, as the Court below *assumed,* of course it reduces basis.

Second, the statute uses the words "allowed" and "allowable" in clear contrast to each other; and a full appreciation of the vital distinction between the respective meanings of these words is essential to any understanding of the issue involved. Obvious as the distinction may seem, it has been constantly ignored.

The word "allowable" in the subsection quoted refers to the depreciation which the taxpayer is legally entitled to deduct in any year. The taxpayer has no more option as to whether and when such depreciation must be deducted than he has with reference to any other deduction accruing in a particular year. There is a wasting of the property to that extent in the particular year and it must be deducted just as would be true of rent or interest or a loss on a sale or any deduction accruing in a particular year. It is immaterial that it may not reduce taxable income nor result in any tax advantage. The requirement that "allowable" depreciation, like all other expenses actually accruing in any year, be taken in the year in which it occurs, regardless of whether there is any income against which it may apply, is inherent in the theory of the computation of income and taxes upon an annual basis (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301). The taxpayer is clearly required to deduct the "allowable" depreciation for each and every year in adjusting the basis of property for computing gain or loss on sale or for computing depreciation for subsequent years. It is and has always been admitted by petitioner that the 5% depreciation "allowable" for each of the years 1931 to 1936 inclusive must be deducted from basis whether or not it reduced taxable income one iota or saved petitioner one penny of tax. Petitioner has never suggested otherwise.

Now as to the word "allowed" as used in Section 113(b)(1)(B). *In those cases where it is applicable* the word "allowed" as there used clearly has the effect of

requiring a reduction of basis by an amount of depreciation which is in excess of the depreciation legally and properly deductible. Otherwise the word "allowed" would be pure surplusage. The word "allowable" standing alone is entirely ample to require the reduction of the basis by the full amount of the depreciation properly deductible. It is clear therefore that the word "allowed" was inserted to require *in some instances* the reduction of basis on account of depreciation which has been deducted improperly and without legal authority in prior years.

2. Legislative History of Section 113(b)(1)(B).

An examination of the legislative history of Section 113(b)(1)(B)[4] makes it clear that *the particular instances* in which Congress wished to bind a taxpayer because of improper and excessive deductions of depreciation in prior years were where such excessive and improper deductions resulted in reducing taxable income in prior years and the statute of limitations prevents recovery of the taxes justly due for such prior years.

Prior to the Revenue Act of 1924 there was no specific provision with respect to adjustment for depreciation in computing gain or loss from a sale of property. In spite of this fact the courts held that when property is sold the basis thereof must be reduced by the aggregate amount of depreciation which was legally "allowable" in prior years.

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[4] The well settled principle that explanatory legislative history will be considered in construing a statute needs no citation of authority. It seems appropriate, however, to refer to the following recent statement of Mr. Justice Murphy speaking for the court in the case of *Harrison* v. *Northern Trust Co.*, 317 U. S. 476, 479:

> "But words are inexact tools at best, and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how 'clear the words may appear on "superficial examination" ' ".

See *United States* v. *Ludey*,[5] *supra; Hardwick Realty Co.* v. *Commissioner, supra.*

Section 202 (b) of the Revenue Act of 1924 (43 Stat. 253) provided that in computing gain or loss, adjustments should be made for depreciation "previously allowed." The word "allowed" as used in this section of the 1924 Act seems never to have been judicially construed. It does appear from the report of the Senate Finance Committee (Sen. Rep. 398, p. 13; 6th Cong., 1st Sess.) that the words "properly chargeable" were incorporated originally in the House Bill. The only reason stated for the substitution of the words "previously allowed" by the Senate for the words "properly chargeable" is "to remove a possible ambiguity in the House Bill".

Section 202 (b) of the Revenue Act of 1926 (44 Stat. 9) and Section 111(b)(2) of the Revenue Act of 1928 (45 Stat. 791) provided for adjusting basis by deduction of the depreciation which, since the acquisition of the property, had been "allowable" in respect of such property; and made no provision for the deduction of depreciation "allowed." The Senate Finance Committee Report on the 1926 Act (Sen. Rep. 52, p. 15, 69th Cong., 1st Sess.) indicated that the purpose of changing from the words "previously allowed" used in the Revenue Act of 1924 was to prevent a taxpayer from electing to take no depreciation "against his annual income" and writing off his entire cost at the time of sale.

In the years between 1926 and 1932, however, it became evident that the section as drawn was unsatisfactory, be-

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[5] In *United States* v. *Ludey*, Mr. Justice Brandeis said (274 U. S. at p. 304):

> "On the other hand, we cannot accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount *which the taxpayer was entitled to deduct* in the several years." (Emphasis supplied.)

cause some taxpayers who had obtained the benefit in prior years of deductions against income for depreciation in excess of the amount "allowable" were, upon sale, insisting upon adjusting the cost basis of their property only to the extent of the "allowable" depreciation and were thus seeking to obtain a double deduction to the extent of the difference between the "allowable" depreciation and the excessive depreciation deducted from income in prior years. It was this situation which Congress recognized as requiring its attention when it drafted the Revenue Act of 1932 (47 Stat. 169). Without in any way changing the requirement for the deduction in each year of the amount of depreciation "allowable" in such year, Congress provided, in Section 113(b)(1)(B) of the Revenue Act of 1932, against a taxpayer claiming a double deduction by requiring that basis should be adjusted for depreciation—

> "to the extent allowed (but not less than the amount allowable)".

The provisions of this section have been incorporated without change, as Section 113(b)(1)(B), in all subsequent Revenue Acts. The Senate and the House committees, in substantially identical language, explained the reason for the change. The Senate Finance Committee Report (Sen. Rep. 665, p. 29, 72nd Cong., 1st Sess.) contains the following statement:

> "In subparagraph (B), [of Sec. 113(b)(1)], relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of 'by the amount * * * allowable' as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's

present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer and the Treasury should not be penalized for having approved the taxpayer's deductions. While the Committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.'"[6]

A consideration of this statement of the Committees makes it clear that the sole purpose of Congress in adding

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[6] The quoted portion above is identical in the Senate and House Reports. The Senate Report, however, contains two additional sentences, which do not appear in the earlier House Report, as follows:

> "Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

The Court below apparently considered the foregoing sentences as indicating Congressional intention that respondent's construction of Section 113(b)(1)(B) be accepted. As a matter of fact, those sentences do not relate to the amendment which Congress was then enacting. Those sentences relate to other suggestions which the Committee had apparently considered—suggestions for other possible amendments to the Section *to prevent the Commissioner from treating the taxpayer unfairly* by retroactive changes of position. They certainly do not indicate that the amendment which Congress was enacting to prevent the taxpayer from obtaining the inequitable advantage of a double deduction should be used to bind him to an error from which he has obtained no advantage of any sort and from which the Treasury has suffered no loss.

the requirement that depreciation "allowed" as well as that "allowable", be deducted was to require the deduction of excessive and improperly deducted depreciation whereever the deduction has resulted in reducing taxable income in the earlier year *and* the Commissioner is barred from recovering the taxes justly due in the earlier years. The statement refers to the fact that the Treasury has frequently encountered cases where a taxpayer seeks to obtain the benefit of a double deduction by contending that the depreciation "taken and allowed" in prior years was not actually deductible. It states that it does not want the Treasury *penalized* by such a change of position. All these statements can have reference only to a situation where just taxes have been avoided. They would be meaningless in a case where no taxes have been avoided.

The Circuit Court of Appeals for the Third Circuit in *Pittsburgh Brewing Co.* v. *Commissioner*, 107 F. (2d) 155, reviewing the legislative history, makes the following statement (at p. 156):

> "Obviously the Committee referred to the situation in which a taxpayer, having had the benefit of a larger depreciation deduction from gross income than was properly allowable to him, claims upon the sale of the depreciated property that his sale basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. We think it clear that it was to prevent the possibility of such a double deduction that the provisions of the Revenue Act of 1932 which we are considering were enacted. No double benefit can be received where, as in the case before us, the depreciation originally claimed offset no income which would otherwise have been taxable."

The last sentence in the quotation from the Senate Report set forth in the text, supra (pp. 13-14), is especially significant. It says:

> "*While the Committee does not regard the existing law as countenancing any such inequitable results*, it believes the new bill should specifically preclude any such possibility." (Emphasis supplied.)

The Committee in the italicized portion of the sentence is referring to the situation existing under the 1928 Act which provided for the deduction from basis of only depreciation "allowable" in prior years and made no provision for any adjustment for depreciation in excess of that allowable which had been reported by a taxpayer on its returns. If *under the 1928 Act* the Treasury could be protected against "any such inequitable result", it was only by preventing, upon some principle analogous to estoppel, the correction of the prior error. *Damage* of course would be an essential element, and damage could exist only where there was some avoidance of tax, and there could be no avoidance of tax where no tax was due. Therefore under the 1928 Act the Treasury clearly could not have bound the taxpayer in a situation like the present on account of its error in reporting excessive depreciation on its returns for prior years. That being true, and since the amendment in 1932 was intended to give the Treasury *statutory* protection in only those situations where the Committees felt that *equity* already may have afforded protection, the statute obviously was not intended to apply in a situation like the present where every equity is with the taxpayer and against the Treasury.

3. Ordinary meaning of the word "allowed".

If, in order to give the subsection the effect clearly intended by Congress, as shown by the reports of both Congressional Committees, it were necessary to give to the word "allowed" a strained and unnatural meaning, the interpretation of the subsection would present difficulty. But quite the contrary is true. The usual and ordinary meaning of the word, "allowed," fits clearly into the Congressional purpose. The word "allowed" in ordinary usage means "To grant (something) as a deduction or an addition; esp. to abate or deduct; as, to allow a sum for leakage." (Webster's International Dictionary, 2nd Ed.). After referring to the foregoing definition, the Circuit Court of Appeals for the Third Circuit in *Pittsburgh*

Brewing Co. v. *Commissioner,* supra, quite correctly concluded that the word " 'allowed' in the statute accordingly means granted as a deduction." And that court correctly, as we think, took the view that if, after there are deducted from the correct gross income only the proper and legal deductions leaving no income against which a deduction of improper and excessive depreciation may be taken, such excessive depreciation is not "allowed" as a deduction. How was the deduction "allowed" when there was nothing against which it could be "allowed" and where there was not even any reason for considering whether it should be allowed?

4. General attitude of Congress and Commissioner toward erroneous deductions.

The correctness of petitioner's construction of the subsection is confirmed by another consideration of the utmost importance. No case will be found—unless the present be such a case—where Congress has ever sought to bind a taxpayer for the future by reason of past erroneous and unauthorized treatment of items of income or deductions, *unless* a change of position will result in depriving the government of taxes to which it is justly entitled. Such a situation can arise only if the error in the earlier year resulted in reducing the taxes which would otherwise have been payable in that year *and* the statute of limitations has barred the correction of the error. We know of no single situation other than this depreciation situation where the Commissioner has attempted to bind the taxpayer by past errors, except where it is necessary to prevent an injustice to the public revenue, a situation which can arise only if taxes have been avoided in the earlier year and the statute of limitations has run. The Commissioner's position here is based not upon any claim of equity but solely upon his alleged interpretation of the word "allowed." It has been the universal practice of the Commissioner not to perpetuate errors of income or deduction nor to carry forward into other years

the effect of such errors *unless* to do so will deprive the government of taxes to which it is justly entitled.

One very simple example—an example closely analogous to the depreciation situation—will serve to show how errors in past years are generally treated: Suppose a taxpayer buys a 10 acre tract of land for $10,000.00. He sells 5 acres for $10,000.00 and in figuring the profit on the sale attributes $7,500.00 of the cost to the 10 acres sold. On a later sale of the other 5 acres for $10,000.00 he seeks to attribute $5,000.00 of the cost to the latter 5 acres, which we shall assume is a correct division of the cost. *If* a reduction of the taxes which otherwise would have been due resulted from the use of the erroneous division of cost on the sale of the first 5 acres *and if* the statute of limitations had barred the correction of the error in the earlier year, the Commissioner might attempt on some theory of estoppel or *quasi*-estoppel to bar the taxpayer from using a cost of more than $2,500.00 on the second 5 acres. If, on the other hand, the statute of limitations had not run or if no tax benefit resulted from the erroneous treatment of the sale of the first 5 acres, the Commissioner undoubtedly would not even suggest—and certainly no court would think of holding—that the error in the earlier year would prevent the correct computation of income in the later year.

The deduction for depreciation is quite similar to a sale of property fractionally each year. If the taxpayer treats as wasting in any one year a greater fraction of cost than is proper, the only reason that would justify an attempt by the government to perpetuate rather than to correct the error would be that the correction of the error of the earlier year would result in additional taxes which cannot now be collected because barred. Where no taxes would be due in the earlier year if the error were corrected or where the collection of such taxes as would result is not barred, there can be no reason whatever for deducting from basis an amount of depreciation greater than that legally "allowable" in the earlier year. A holding to the contrary would place erroneous and improper deductions of depreciation in a different situation from all other erroneous deductions.

There is no sound basis for respondent's refusal to correct this error under circumstances under which all other errors would be corrected.

It is significant that, when in 1938 the Treasury came to propose to Congress general provisions to protect the Government and taxpayers against changes in position by the other party, it did not recommend that Congress bind the party to an erroneous position taken in a prior year even where such error had affected tax liability in such prior year. The Treasury suggested on the contrary that where a position inconsistent with a prior erroneous position is successfully maintained in a later year the statute of limitations shall be opened up for the collection or refund for such prior year of whatever tax results from correcting the error. This is the basis of the relief provisions adopted by Congress in Sections 3801 and 734 of the Internal Revenue Code. The Senate Committee in reporting out Section 3801, which first came into the law as Section 820 of the Revenue Act of 1938 (the very act here under consideration) expressly stated (Sen. Rep. No. 1567, pp. 48-50, 75th Cong. 3rd Sess.), that one of the principles upon which the legislation proceeded was that:

> "Corrective adjustments should produce the effect of attributing income or deductions to the right year and the right taxpayer, and of establishing the proper basis."

And yet the Commissioner in the present case insists upon establishing an erroneous basis by the perpetuation of an error which had no tax effect in the prior year and the perpetuation of which is not required by any considerations of justice.

5. Legislative approval of Petitioner's Construction of Section 113(b)(1)(B).

There is an additional circumstance in the recent legislative history of Section 113(b)(1)(B) which seems to us to show that Congress intended the construction advanced by petitioner. That subsection, as enacted in 1932, is now in-

cluded without any material change as Section 113(b)(1)(B) of the Internal Revenue Code. In October of 1942, when the Revenue Act of 1942 was enacted, the issue involved herein as to the proper construction of the word "allowed" in that subsection was squarely involved in four reported cases, namely, *Pittsburgh Brewing Co.* v. *Commissioner*, supra, *Kennedy Laundry Co.*, 46 B. T. A. 70, *Don Lee, Inc.* v. *U. S.*, 42 F. Supp. 884 (N. D. Cal.); and the Board's decision in the case at bar.[7] Every one of these cases had construed the meaning of the word "allowed" in accordance with the construction advanced by petitioner herein and no case had been decided in favor of the construction advanced by respondent. The *Pittsburgh Brewing Co.* case, supra, had been decided as long ago as 1939. With this judicial record before it Congress did not change one word of subsection (B) of Section 113(b)(1) although it amended Section 113(b)(1) in a number of respects. This certainly suggests, to say the least, that the uniform construction of the word "allowed" by the Board of Tax Appeals and the Courts met with Congressional approval. It was not until the Fourth Circuit handed down its decision in this case in January, 1943, months after the enactment of the Revenue Act of 1942, that any case was decided supporting the construction advanced by respondent.

6. Unfairness of Section 113(b)(1)(B) as Construed by Respondent.

The construction advanced by petitioner cannot in any way work unfairly against the government. It is to be noted,

[7] The *Kennedy Laundry Co.* decision of the Board has since been reversed by the Circuit Court of Appeals for the Seventh Circuit (133 Fed. (2d) 660) and is now pending here on petition for writ of certiorari, No. 958. The decision of the District Court in the *Don Lee* case is pending on appeal in the Circuit Court of Appeals for the Ninth Circuit. On November 3, 1942, the District Court for the District of Utah, in the case of *Gunnison Sugar Co.* v. *Hinckley*, 1942 C. C. H. § 9812, rendered another decision in favor of petitioner's position.

however, that the Circuit Court for the Fourth Circuit in deciding the present case against the taxpayer recognized the unfairness of the result to the taxpayer. The Court said (R. 52):

> "The method used by Commissioner for computing depreciation through the remaining years of useful life of the property seems to involve hardship in view of the fact that the taxpayer has received but little tax benefit for the depreciation allowed, and the rates for the remainder of the useful life are less than they would have been if the rates and useful life had been correctly computed in the first instance."

The recognition of the injustice which results from the Court's construction should be persuasive that Congress must have intended the opposite construction. In the absence of language clear enough to compel it, it is difficult to understand how the Court, in attempting to determine the intention of Congress, could arrive at the conclusion that Congress intended to accomplish a result which is contrary to all past practice and in no way suggested by the legislative history of the subsection and which is admittedly unfair.

Conclusion

Petitioner submits that the United States Circuit Court of Appeals for the Fourth Circuit was clearly in error in deciding that petitioner's depreciable assets as of December 31, 1937 must be reduced by $31,400.25, the amount of the excessive depreciation improperly reported on its returns in the years 1931 to 1936 inclusive, where such excessive depreciation did not reduce petitioner's taxable income. The judgment of the Court below should be reversed.

Respectfully submitted,

F. G. Davidson, Jr.,
Noah A. Stancliffe,
Theodore L. Harrison,
J. Donald Rawlings,
W. A. Sutherland,
Counsel for Petitioner.

INDEX

CITATIONS

516904—43

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 766

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 34–38) is unreported. The opinion of the Circuit Court of Appeals (R. 45–52) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 2, 1943 (R. 53). The petition for a writ of certiorari was filed February 25, 1943. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in computing depreciation for the year 1938 under Sections 23, 113, and 114 of the Revenue Act of 1938, the taxpayer's basis as of December 31, 1937, should be reduced by the amount deducted for depreciation in prior years in excess of that properly allowable where the excess was not offset by taxable net income for those years.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> * * * * *
>
> (n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.
>
> * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

The applicable regulations are Articles 23 (l)-1, 2, 4, 5 and 9, 113 (b)-1 and 114-1 of Treasury

Regulations 101, relating to the Revenue Act of 1938.

STATEMENT

The following facts were stipulated (R. 9–17, 22–33) and found by the Board of Tax Appeals (R. 34–38):

The taxpayer is a Virginia corporation which has operated a hotel in Lynchburg, Virginia, since January 1, 1931 (R. 22, 34). In making its returns from that time through the year 1937, it claimed and was allowed depreciation at straight-line rates of 10 percent on all of its equipment except carpets and upon these at 15 percent, based upon an estimated useful life of 10 and 6⅔ years, respectively (R. 25, 37). For the year 1938 the taxpayer claimed a deduction for depreciation at the same rates; but the Commissioner determined that the useful life of the equipment had been underestimated and that the rates of depreciation allowed were excessive. The useful life of the equipment, except carpets, was estimated at 20 years and carpets at 12½ years. From the cost of the property, the depreciation theretofore claimed as a deduction was subtracted, and the remainder was taken as the new base for computing depreciation. As a result, the Commissioner disallowed $3,046.50 of the amount of depreciation claimed by the taxpayer in its return, thus allowing a deduction in the amount of $1,295.47 (R. 10–12, 15–17, 25, 37).

The taxpayer sustained a net loss for the years 1931 to 1936, inclusive, and the entire amount of depreciation deducted in its returns for those years did not serve to reduce taxable income. The year 1937 resulted in a net gain and the depreciation deducted on the income-tax return for that year did serve to reduce taxable income (R. 25, 37).

In the proceedings before the Board of Tax Appeals, the taxpayer did not question the Commissioner's determination as to the new rates for depreciation but it did contend that its base as of December 31, 1937, should include $31,400.25, that being the amount deducted for depreciation in 1931–1936 in excess of that allowable at the new rates. Such inclusion would result in a depreciation allowance of $4,438.14 for 1938 (R. 25–26, 37–38).

The Board of Tax Appeals upheld the taxpayer's contention (R. 38) but the court below reversed (R. 52).

ARGUMENT

Sections 113 (b) (1) (B) and 114 (a) of the Revenue Act of 1938, *supra,* provide that in determining the basis for depreciation, proper adjustment shall be made in respect of earlier years, for depreciation, "to the extent allowed (but not less than the amount allowable)" under the Act or prior income tax laws. The court below held,

correctly we submit, that depreciation is "allowed" within the meaning of the statute, where claimed by the taxpayer and not opposed by the Commissioner, even though the taxpayer has no net income which is offset thereby. In so holding, the court said (R. 49) there is nothing in the statute, or elsewhere, which justifies restoring to the base the depreciation which has been claimed and allowed in prior returns, merely because such allowance has resulted in no tax benefit. Cf. *Mother Lode Coalition Mines Co.* v. *Helvering*, decided December 7, 1942, No. 94, present Term, not yet officially reported.

Although the instant decision appears to be in conflict with *Pittsburgh Brewing Co.* v. *Commissioner*, 107 F. 2d 155 (C. C. A. 3), as asserted by petitioner (Pet. 5, Br. 10, 13–15), the situation is not one that calls for certiorari, for the existence of a *present* conflict between the two circuits is open to serious question. As indicated by the court below (R. 52), the authority of the *Pittsburgh Brewing Co.* decision has been considerably shaken by a later decision of the same court. *Commissioner* v. *United States & Int. Sec. Corp.*, 130 F. 2d 894. In this subsequent case, the Third Circuit held that amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the

taxpayer.[1] In so holding, the court did not mention the *Pittsburgh Brewing Co.* case, but since the two decisions cannot consistently stand together and the later one must be accepted as representing the present views of the court, the *Pittsburgh Brewing* case cannot be regarded as authoritative now in the Third Circuit. Accordingly, in the absence of any present conflict among the circuits, the Court would be justified in denying certiorari.

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[1] The court has granted a rehearing in this case to determine the effect of Section 116 of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., which provides:

"SEC. 116. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

"(a) *Exclusion From Income.*—Section 22 (b) (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

"'(12) *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

"'(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

"'(B) *Definition of Prior Tax.*—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

"'(C) *Definition of Delinquency Amount.*—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time re-

The problem has also reached decision in the Seventh Circuit, and the Circuit Court of Appeals for that circuit followed the instant decision (*Commissioner* v. *Kennedy Laundry Co.*, decided

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quired by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

"'(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.'

* * * * * * *

"(b) *Effective Date of Amendments Under the Internal Revenue Code.*—The amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1938.

"(c) *Under Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act, the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such revenue Act on the date of its enactment."

The new regulations have not yet been issued.

There is no comparable provision in the 1942 Act with respect to depreciation and in the circumstances it seems clear that the allowance of an exclusion in a case specifically covered by the statute would not require a similar result here. Indeed, we submit that the method of treatment in the 1942 Act indicates that unless otherwise specifically provided, a deduction should be accorded full significance without regard to whether the claimant derived a tax benefit therefrom.

February 15, 1943), reversing the decision of the Board of Tax Appeals (*Kennedy Laundry Co.* v. *Commissioner*, 46 B. T. A. 70) relied on by petitioner (Pet. 5; Br. 10). The problem is now pending in the Ninth Circuit, on appeal from *Don Lee, Inc.* v. *United States*, 42 F. Supp. 884 (N. D. Cal.), also cited by the taxpayer (Pet. 5; Br. 10).

In the circumstances, we submit that there is at present no sufficient reason for the granting of the instant application.

CONCLUSION

The decision is correct and the petition should be denied.

Respectfully submitted.

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INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1942

No. 766

Virginian Hotel Corporation of Lynchburg, petitioner

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 34–38) is unreported. The opinion of the Circuit Court of Appeals (R. 45–52) is reported in 132 F. (2d) 909.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 2, 1943 (R. 53). The petition for a writ of certiorari was filed February 25, 1943, and was granted April 5, 1943. The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

In its returns for the years 1931–1936 petitioner took deductions for depreciation which were not challenged by the Commissioner of Internal Revenue but are now found to have exceeded the amounts properly allowable. The deductions did not offset taxable income. The question is whether, in determining the adjusted basis of the property for the purpose of computing depreciation for the year 1938 under Sections 23, 113, and 114 of the Revenue Act of 1938, the cost basis should be reduced by all the excessive deductions taken in the earlier years, or only by the amount which offset gross income. The answer depends upon whether these deductions were "allowed" within the meaning of Section 113 (b) (1) (B) of the Act.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> *   *   *   *   *
>
> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> *   *   *   *   *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) * * * The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis pro-

vided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 113 (b)-1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (18), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).
>
> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *
>
> * * * * *
>
> The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under the Revenue Act of 1938 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto,

whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. * * *

* * * * *

The other applicable regulations are Articles 23 (l)-1, 23 (l)-2, 23 (l)-4, 23 (l)-5, 23 (l)-9, and 114-1 of Treasury Regulations 101.

STATEMENT

The following facts were stipulated (R. 9-17, 22-33) and found by the Board of Tax Appeals (R. 34-38):

Petitioner, a Virginia corporation, was incorporated in 1930 as successor to a partnership which had operated a hotel in Lynchburg, Virginia, since June 1, 1927. Petitioner continued these operations. (R. 34.) Each year from June 1, 1927, through 1937, depreciation was taken without objection at straight line rates of 10 percent on all of its equipment except carpets and upon these of 15 percent, based upon an estimated useful life of 10 and 6⅔ years, respectively (R. 25, 37). For

the year 1938 petitioner claimed a deduction for depreciation at the same rates, but the Commissioner determined that the useful life of the equipment had been underestimated and that the rates of depreciation allowed were excessive. The useful life of the equipment, except carpets, was estimated at 20 years and carpets at 12½ years, resulting in depreciation rates of 5 percent and 8 percent, respectively. In the computation of the deficiency, the depreciation theretofore claimed as a deduction was subtracted from the cost of the property, and the remainder was taken as the new basis for computing depreciation. As a result, the Commissioner disallowed $3,046.50 of the amount of depreciation claimed by the taxpayer in its return, thus allowing a deduction in the amount of $1,295.47. (R. 10-12, 15-17, 25, 37.)

The partnership had had a net gain for each of the years from June 1, 1927, to December 31, 1930, and petitioner had a net gain in 1937. The deductions taken for depreciation in those years served to reduce taxable income. Petitioner sustained a net loss for each of the years 1931 to 1936, however, and the excessive depreciation deducted in its returns for those years did not serve to reduce its taxable income. (R. 25, 37.)

In the proceedings before the Board of Tax Appeals, petitioner did not question the new rates. Its contention was that the depreciation claimed for the years 1931 through 1936 in excess of the amount properly allowable, which did not serve to

reduce taxable income in those years, should not be subtracted from the depreciation basis. (R. 38.) The Board of Tax Appeals sustained petitioner (R. 38), but the court below reversed (R. 52).

SUMMARY OF ARGUMENT

Section 113 (b) (1) (B) of the Revenue Act provides that the basis for computing depreciation shall be adjusted for prior depreciation "allowed (but not less than the amount allowable)." Because it now appears that petitioner took excessive deductions for depreciation, the issue here is whether the word "allowed" refers simply to deductions taken on petitioner's return and not disallowed by the Commissioner, or requires also that the deduction reduce petitioner's tax. Petitioner claims the latter meaning must be adopted to avoid hardship. The hardship which petitioner finds in the Commissioner's contrary position is nonexistent: if any hardship resulted it would flow from petitioner's own voluntary act of deducting more than allowable amounts for depreciation and would have been present even if the Commissioner had permitted petitioner to continue to deduct the excessive amounts of its own choosing. Moreover, petitioner's position would actually place those deducting excessive depreciation in a more favorable position for some purposes than other taxpayers, a tax subsidy which surely Congress did not intend.

The tax benefit theory does not inhere in the word "allow" any more than it does in the companion

word "allowable." Moreover, the legislative history from which petitioner draws a Congressional purpose to limit "allowed" by a tax benefit qualification not only does not support petitioner but actually shows a purpose which petitioner's construction would flaunt. Finally, the 1942 legislation, which provides that recoveries of bad debts and taxes shall be included in taxable income only if prior deductions had resulted in a tax reduction, recognizes that, in the absence of such specific provision, there is no tax benefit theory in the income tax laws. The legislation writes the requirement into the statutes only for certain carefully defined items, of which excessive depreciation is not one. Judicial adoption of the rule in this situation would result in inconsistencies with the application of the statutory amendments.

ARGUMENT

THE COURT BELOW CORRECTLY HELD THAT THE TAXPAYER'S BASIS FOR DEPRECIATION SHOULD BE ADJUSTED BY THE ENTIRE AMOUNT OF DEPRECIATION CLAIMED FOR PRIOR YEARS.

Section 114 (a) of the Revenue Act of 1938, *supra,* provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b), *supra,* for the purpose of determining the gain upon sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation, "to the extent allowed

(but not less than the amount allowable)" under the Act or prior income tax laws.

The instant case turns on the meaning of the word "allowed." We submit that the court below correctly held that depreciation is "allowed" within the meaning of the statute, where it is claimed by the taxpayer and not disallowed by the Commissioner. The petitioner's contention is that the deduction must also offset net income. But we find nothing in the statute, the regulations, the legislative history, or the relevant considerations of administrative practice, which supports the conclusion that a deduction can be treated as allowed only when it results in such a tax advantage to the taxpayer. On the contrary, the available evidence supports the interpretation adopted by the Government.

1. It is important at the outset to emphasize that the Government's position is both reasonable and consistent with the theory of the statute. It becomes evident, upon analysis, not merely that the taxpayer's claims of hardship are unwarranted, but that its construction of the statute would place a premium upon claims for excessive depreciation allowances.

The statutory allowances for depreciation provide a taxpayer an opportunity to recover tax-free his investment in property which is used in producing income and is being consumed or is

deteriorating in the process.[1] In taking the deductions, he is required to estimate in advance the anticipated life of the property and is required to spread the deductions over that estimated life. Thus, if he estimates that the property will have a useful life of 20 years, he will each year deduct from income 1/20 of the cost or other basis of the property; accordingly, over the 20 years he is deriving income from the property he will be permitted to take deductions equal to his investment in the property.

Based as it is on beforehand estimates of useful life, the method, of course, cannot be precise and adjustments will sometimes be necessary. Experience with the property will often show that the useful life of the property has been overestimated or underestimated. When this occurs, a new estimate is made, and the basis of the property, to the extent that it has not been recovered by prior deductions, is spread over the remaining life as thus reappraised.[2] This is accomplished

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[1] Depletion is the name given to the process and method when wasting-asset properties, such as mines and wells, are involved. Though closely allied to depreciation, depletion is and always has been governed by different statutory provisions. Cf. *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 524–525. See I. R. C. Section 114 (b). The depletion allowance, to an even greater extent than the depreciation allowance, does not contemplate an exact recovery of investment.

[2] No adjustment is made for the depreciation deductions for the years preceding the reappraisal which are still open under the statute of limitations. *Sample-Durick Co.* v. *Commissioner*, 35 B. T. A. 1186.

under the statute involved here, by reducing the original basis by depreciation previously "allowed," or that "allowable," whichever amount is greater, and by applying to this adjusted basis the new rate calculated upon the new estimate of useful life. For example, if after 15 years it were determined that property, instead of having a 20-year life (with 5 years remaining), had a 25-year life (with 10 years remaining), the remaining unrecovered basis would be spread over 10 years instead of 5. As a consequence, the deduction for each year would be half as large as under the original computation, but the privilege of taking depreciation deductions would last twice as long.[3]

Such a change does not reduce or increase the total amount of depreciation the taxpayer will be permitted to deduct. The change merely increases the number of years over which the deduction will be spread. Thus in the case at bar, the Government's position will permit petitioner to deduct the same total sum for depreciation as if it had been permitted to continue deducting excessive amounts until the basis was exhausted. The only difference is that petitioner will now

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[3] This general method is not challenged by petitioner, and petitioner's own computation of the basis of its property accepts the Treasury position that "allowable" depreciation is that which could have been properly deducted, regardless of tax benefit. (R. 25–26.) Petitioner's contention herein is, however, that "allowed" depreciation is only that which was deducted to the tax benefit of the taxpayer.

deduct smaller amounts each year over a longer period. This will mean that petitioner's net income for the immediate years will be greater than if it still deducted excessive depreciation. But it will also mean that petitioner's net income will be less in subsequent years than otherwise because depreciation will still be available to offset gross income for those subsequent years; whereas if petitioner had gone on its way deducting excessive amounts now its basis would have been entirely exhausted in those subsequent years, in which the property will still produce income.

It is delusive, therefore, to speak of hardship or unfairness in this situation. It is impossible to tell whether or not the Government's position will cause petitioner in the long run to pay higher taxes than its own error uncorrected would have caused it to pay and no intelligent guess can be made. It may pay less. Any hardship resulting from the wasted depreciation deductions of past years would have been present even if the Commissioner had not prevented petitioner from continuing to take excessive deductions. That hardship is one of the taxpayer's own making in taking the excessive deductions—a point emphasized by the fact that the determination of the correct depreciation rate rests on facts peculiarly within petitioner's own knowledge and involves a judgment which in the first instance petitioner was best equipped to make. Cf. *Helvering* v. *Lerner Stores Co.*, 314 U. S. 463.

The taxpayer, however, would turn the rate reduction to its definite advantage. Except insofar as the statutes have specifically provided for loss carry-overs,[4] the revenue laws do not contemplate that a taxpayer shall be allowed to take advantage in a later year of deductions available in earlier years which gave it no tax benefit because of insufficiency of income. Each tax year stands on its own footing. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. Consistently with the depreciation schedule which had been employed since 1927, with the approval of the Commissioner, the taxpayer continued to take these deductions through its loss years 1931–1936. The deductions were actually available to it, just like any other deduction to which it was then entitled, although it was subsequently found that the amount had been excessive. Indeed, the taxpayer continued to use the same rate in the year 1937 when it had net income and admittedly derived a tax benefit from the excessive claim, which it could not have done if it had undertaken to reduce the rate. Ordinarily the taxpayer could not expect to recoup the deductions wasted in its bad years. What its position here means is that the necessity of having to reduce the rate in 1938 should serve as an occasion to permit it to recoup its wasted deductions. This would not

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[4] For an outline of the history of the net loss carry-over provisions, see Mertens, *Law of Federal Income Taxation*, Sec. 29.01 *et seq.* See also Revenue Act of 1942, Sections 150 (e), 153, 204.

have been permitted if the rates had not been changed; there is no reason why this circumstance should serve as an excuse.

On the other hand, the petitioner's position is not only inconsistent with the basic principles underlying the theory of depreciation allowances, but also it would provide taxpayers an incentive to make their claims for depreciation excessive. The statutory method of allowing for depreciation contemplates annually recurring deductions. These deductions will afford the taxpayer the opportunities of (1) reducing each year's gross income from the property by an amount equal to the estimated depreciation in value for that year, and of (2) recovering his investment tax-free. But while each of these opportunities is afforded the taxpayer, neither is guaranteed him. If a taxpayer continues to use property in his business and to produce gross income with it after it has been fully depreciated, he will receive no further depreciation deductions with which to reduce his gross income. On the other hand, if the amount properly "allowable" as the annual depreciation deduction exceeds the gross income in one or more years, so that some of the properly allowable deduction does not produce a tax saving, the taxpayer, as the petitioner concedes,[5] is not given a second chance to deduct so much of the depreciation as was not beneficially deducted the first time; yet the conse-

[5] Cases compelling that concession are: *Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318 (C. C. A. 2d); *Herder* v. *Helver-*

quences of denying him the second chance will be that he will not recover his entire investment tax-free.

This system of depreciation contemplates a consistent pattern of annual deduction, to which the taxpayer is required to adhere. He is not permitted to vary the size of the deduction according to his need for it. An even flow of depreciation is ordinarily contemplated. And it is in accordance with this principle that the taxpayer's basis will be reduced by the correct depreciation "allowable," regardless of whether or not the deductions may have offset income. To hold otherwise, as this Court has pointed out (*United States* v. *Ludey*, 274 U. S. 295, 304) would permit the taxpayer to choose the year in which he will take the deduction; or, stated a bit differently, would permit the taxpayer to reserve some of the depreciation deduction for the years when it would do him the most good.

The petitioner, however, argues for the application of a different rule where it is later found that a portion of the allowance taken was excessive. We think it impossible to reconcile this position with these basic principles. We think there

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ing, 106 F. 2d 153, 162 (App. D. C.), certiorari denied, 308 U. S. 617; *Jones* v. *Commissioner*, 72 F. 2d 114 (C. C. A. 8th); *Kittredge* v. *Commissioner*, 88 F. 2d 632 (C. C. A. 2d). Compare *United States* v. *Ludey*, 274 U. S. 295, and *Hardwick Realty Co.* v. *Commissioner*, 29 F. 2d 498 (C. C. A. 2d), reaching the same result prior to the present statute; Regulations 101, Article 113 (b)-1, *supra*, pp. 4-5.)

is no justification for giving a taxpayer, who has made an excessive claim, this opportunity to vary the even flow of the deductions he has taken and, in effect, make use of them in later years when they will be beneficial, because they had not given him a tax advantage in the years they were taken. We do not think that this opportunity should be given with respect to excessive deductions while being denied with respect to those correctly taken.[6]

Petitioner's position has a further undesirable consequence. Because it defines the word "allowed" as referring only to those deductions which are allowed and applied so as to reduce the tax, the necessary extension of petitioner's position, although petitioner does not argue for it, is that whenever it turns out that a taxpayer has estimated too short a life for his property and has exhausted his basis for depreciation before the property has lost its income producing value, he can compel the Commissioner to restore to his

[6] It should be observed that a taxpayer who takes larger depreciation deductions than those properly allowable derives a tax benefit therefrom in each net income year, in the form of a lower income which not only reduces the tax but reduces it in proportion to his income because it puts his income in lower tax brackets. There is thus a clear monetary incentive to overstate the annual deduction, which incentive is not counteracted under petitioner's view by any risk of wasting the excessive deductions in loss years. Instead petitioner would reserve the loss year excessive deductions for use in some year after the available depreciation would otherwise have been exhausted and when petitioner would otherwise have been paying the piper for having earlier taken excessive deductions.

basis all of the excessive depreciation which he deducted and which did not produce a tax saving, and can then deduct that same depreciation a second time. For example, suppose a taxpayer estimated a 20-year life for a building and the Commissioner did not challenge this estimate; and suppose then that at the end of 20 years the building still had some value and produced some income. It is apparent that too short a life was placed on the building and that as a result more depreciation was deducted each year than the amount which, properly calculated, was "allowable." Therefore, if the basis is reduced by "allowable" depreciation only, the basis will not be reduced to zero notwithstanding that the taxpayer has obtained deductions for amounts equal to 100 percent of the basis. The statute, however, provides that the basis in such circumstances shall be reduced by the amounts for which deduction has been "allowed"; under petitioner's construction a taxpayer could at this time, notwithstanding that he had already fully deducted amounts equal to his total basis, figure back over his returns, determine how much of the deductions had not produced a tax saving, and omit those amounts from the basis reduction. He would then have an unrecovered basis from which to extract a second round of depreciation deductions.

This should be contrasted with the position of the taxpayer who, in a conscientious effort to avoid excessive depreciation deductions, errs the other way and estimates a longer life for his property than it actually has. His annual deductions are consequently smaller than those "allowable," and under the statute the basis must be reduced by all "allowable" depreciation. His basis will thus be reduced to zero before he has deducted amounts equal to the basis of the property, and he will have no means of recapturing those lost deductions for years barred by the statute of limitations. Treasury Regulations 101, Art. 113(b)-1, *supra.*

The favored position which the taxpayer who takes excessive depreciation would have is not only undesirable in itself, but it would also have serious consequences on the administration of the income tax. Many taxpayers, particularly when they believed high incomes were in immediate prospect, would be given added encouragement to overstate their depreciation deductions. For they would not be deterred by the risk that if they should have bad years, they would lose all benefit from the excessive deductions. On the other hand, the incentive given by the Government's position is neither to overstate nor to understate the allowance. Since the Commissioner, at least initially, must rely to large extent on the estimates of life

furnished by the taxpayers themselves, we think it clear not merely that the Government's construction of the Act is administratively sound but that the petitioner's position would add greatly to the burden of fair and efficient enforcement of the statute.

2. Petitioner seeks justification for its position by reading into the content of the word "allowed," as used in the statute, a meaning which it does not possess. For the requirement of a tax benefit cannot be read into the statute if the term "allowed" is given its ordinary connotation in tax practice. In the administration of the federal income tax laws, there is no formal procedure for the allowance of deductions taken upon the returns. Unless the Commissioner takes steps to disallow a claim, it stands "allowed." Presumably Congress used the term with its common meaning—and no more—in mind. If a "tax benefit" test had been intended, it would have been easy to say so by a simple reference to amounts "deducted from gross income." Cf. *Mother Lode Co.* v. *Commissioner,* 317 U. S. 222.

Moreover, it is difficult to understand how "allowed" can have connotations of tax benefit when, as we have stated, it is admitted that "allowable" does not. The differences in meaning and purport between the two words, as used in Section 113 (b) (1) (B) are obvious. "Allowable" covers the amounts to which the taxpayer was legally entitled. "Allowed" covers those permitted or

granted by the Bureau.[7] The argument that "allowed" also means that the deduction must offset income, although "allowable" does not, is consistent neither with the plain meaning of these words nor with the inferences to be drawn from the manner of their use.

The Third Circuit Court of Appeals, in *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155, adopted the construction which petitioner urges. The court supported its decision by what it believed were indications in the legislative history of Section 113 (b) (1) (B) that Congress used the word in that section with that meaning. We believe, however, that the court misinterpreted that history.

The first specific provision on this subject was Section 202 (b) of the Revenue Act of 1924, which provided that in computing the adjusted-cost basis deduction should be made for depreciation "previously allowed." The committee reports indicate that the purpose of this provision was simply to

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[7] In I. T. 2944 (XIV-2 Cum. Bull. 126), the terms were defined as follows:

"* * * The word 'allowable' designates the amount permitted or granted by the statutes, as distinguished from the word 'allowed' which refers to the deduction actually permitted or granted by the Bureau. The amount 'allowable' is the minimum for adjustment purposes, the amount 'allowed' serving to measure the adjustment only when the amount thereof exceeds that allowable.

"It follows that the depreciation claimed as a deduction in a return which has been accepted by the Bureau is the amount 'allowed' for that year. * * *"

confirm Treasury practice, as subsequently approved in *United States* v. *Ludey* and *Hardwick Realty Co.* v. *Commissioner, supra,* note 6, and nothing was suggested of any tax-benefit limitation. H. Rep. No. 179, 68th Cong., 1st Sess., pp. 12–13 (1939–1 Cum. Bull. (Part 2) 241, 250); S. Rep. No. 398, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 266, 275); H. Conference Rep. No. 844, 68th Cong., 1st Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 300). Section 202 (b) of the Revenue Act of 1926 dropped the expression "previously allowed" and used in its place depreciation "allowable." So far as appears, this change was effected, not because of any purpose to relieve the taxpayer from the amount of depreciation claimed by him in his return where no tax benefit resulted, but because certain taxpayers contended that under the 1924 Act they were not obliged to take depreciation on a yearly basis and could if they chose use the initial cost basis in determining gain or loss from the sale of the property in a later year, S. Rep. No. 52, 69th Cong., 1st Sess., p. 16 (1939–1 Cum. Bull. (Part 2) 332, 344).[8] This provision is also contained in Section 111 (b) (2) of the Revenue Act of 1928.

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[8] The report stated in part:

"Under existing law in the case of determining gain from the sale or other disposition of property, the cost or March 1, 1913, value of such property is required to be reduced by the amount of depreciation or depletion allowed under prior income tax laws. It has been claimed that the effect of this provision is to allow a taxpayer to elect to take no deprecia-

In Section 113 (b) (1) (B) of the Revenue Act of 1932 the law was again changed so as to provide for adjustment for depreciation "to the extent allowed (but not less than the amount allowable)" under that Act or prior laws. It is this same provision which is contained in the Revenue Act of 1938, involved in the instant case. The occasion for the change in 1932, as stated in the Senate Report, was to prevent a taxpayer who had claimed deduction at a given rate for a period of years from contending in a later year that the earlier rate was excessive and that the amounts which were in fact "allowable" were much less.[9] The report pointed out that in the later year the Government might be barred from collecting the additional taxes due for the earlier years from the application of the amount of deduction later claimed to be "allowable." The report did not concede that the then existing law permitted this result but expressed the belief that "a new bill

tion or depletion against his annual income and to permit him to write off the entire cost or March 1 value at time of sale. The bill as passed by the House provides that the cost or March 1, 1913, value in the case of sale shall be reduced by the amount of depreciation or depletion allowable under prior income tax Acts in computing the gain subject to tax. It is believed that the rule stated by the House bill is the correct rule and that all taxpayers should be required to take proper annual deductions for depreciation and depletion."

[9] Should petitioner prevail herein, a consequence will be, as noted *supra*, pp. 16–17, that the 1932 amendment must be interpreted to compel, insofar as the excessive deductions resulted in no tax benefit, the very result which it was designed to prevent.

should specifically preclude any such possibility." [10] And while the illustration given by the Senate Committee was that of a taxpayer who had achieved a tax benefit from the amount of depreciation "allowed" in earlier years, there is noth-

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[10] The Senate Report provided in full as follows (S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939–1 Cum. Bull. (Part 2) 496, 517):

"In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made 'to the extent allowed (but not less than the amount allowable)' instead of 'by the amount * * * allowable' as in the prior Act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

ing in the report which indicates an understanding that the amount of depreciation "allowed" was restricted to that part of the claimed depreciation from which a tax benefit accrued. Rather, in view of the manner in which Congress had previously used the terms "allowed" and "allowable" interchangeably, and in view of the fact that the term "allowable" was not limited by any theory of tax benefit, the inference is that Congress likewise used the word "allowed" in the same unrestricted sense.

It is thus evident, we submit, that in the *Pittsburgh Brewing* case the Third Circuit Court of Appeals misinterpreted the legislative history of Section 113 (b) (1) (B) and read a meaning into the amendment which actually has the effect of causing a result which the amendment was designed to prevent.[11] It is significant that although a majority of the Board of Tax Appeals bowed to that decision in *Kennedy Laundry Co.* v. *Commissioner,* 46 B. T. A. 70,[12] the only two circuit courts of appeals to consider the problem subsequently have expressly disagreed with the Third Circuit Court of Appeals.[13] Moreover, in *Beckridge*

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[11] See *supra*, note 9, p. 22.

[12] As have two District Courts: *Don Lee, Inc.* v. *United States*, 42 F. Supp. 884 (N. D. Cal.); *Gunnison Sugar Co.* v. *Hinckley*, 1942 C. C. H. § 9812. These cases are pending on appeals to the Ninth and Tenth Circuit Courts of Appeals respectively.

[13] The Fourth Circuit Court of Appeals in the instant case, and the Seventh Circuit Court of Appeals in *Commissioner*

Corp. v. *Commissioner,* 129 F. 2d 318, the Second Circuit Court of Appeals expressed its disapproval of the *Pittsburgh Brewing* decision.

A further error in the *Pittsburgh Brewing* decision is its easy assumption that the excessive depreciation deduction did not serve to offset gross income and reduce the tax because the taxpayer had a net loss equal to or greater than the excessive depreciation deduction. This assumption overlooks the existence of a serious problem and is probably erroneous.[14] While the taxpayer

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v. *Kennedy Laundry Co.*, 133 F. 2d 660. The decision was criticized also in a note in 40 Columbia L. Rev. 540.

[14] It was vigorously challenged by Judge Disney in his dissent in *Kennedy Laundry Co.* v. *Commissioner*, 46 B. T. A. 70, 75 (reversed in 133 F. 2d 660 (C. C. A. 7th)). He said: "* * * The majority opinion in substance is that the net loss was caused by one item, to wit, depreciation of $22,387.60, out of the possibly many deducted items totaling $284,265.33, that is, that such item was the particular one which put the petitioner's account 'in the red.' Omitting the depreciation item, and subtracting $22,387.60 from $284,265.33, leaves $261,877.73 of deductions, and, compared with gross income of $279,043.96, such total of deductions left the petitioner, not with a net loss, but with a net profit of $17,166.23. The majority opinion amounts to saying that such profit was wiped out and converted into a net loss of $5,221.37 by the item of depreciation. I can conceive no reason for saying that it was that particular item of depreciation which caused the net loss. Depreciation is in the same category with all other deductible items. It is based upon wear and tear upon properties, which wear and tear contributes as much to the production of the gross income as does current expense, for example. I therefore discern no reason to distinguish between the deductible items making up the total of $284,265.33 and to say that any one of them caused the net loss. Plainly no single item caused the total.

would not have had net income even in the absence of the excessive depreciation deduction because it had other deductions sufficient in amount to offset all its gross income, this is equally true of each other deduction in equal extent. Therefore it is a *tour de force* to ascribe the failure to offset income solely to the depreciation deduction, when the plain fact is that no one deduction produced the final result but all of them together did. As they all shared in reducing income to a negative figure, each must be given credit for doing so proportionately with its fellows, and consequently the excessive depreciation deduction did so only in the proportion which it bears to all the other deductions. It follows, therefore, that some part of the depreciation deduction did produce a tax saving and some did not. This analysis is supported by the decision in *Butler Bros.* v. *McColgan,* 315 U. S. 501, 508–509, where, in considering a comparable problem arising out of the allocation of income between states for state tax purposes, this Court refused to countenance the singling out of one item as solely chargeable with producing a negative result where several items

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Though it well may be that depreciation should logically be considered as contributing to the net loss, I can see no rational principle under which to consider it so to do except ratably in the proportion that $22,387.60 bears to $284,265.33. In other words, the net loss is seen to be caused by depreciation, only to the extent of the fraction of 22,387.60/284,265.33 of $5,221.37. * * *"

necessarily contributed to it. We submit, therefore, that in the absence of a legislative declaration that some particular deduction shall be singled out and credited with not offsetting gross income and thus not producing a tax saving, a court may not, as the Third Circuit Court of Appeals did, charge a single deduction to the exclusion of all others with not effecting a tax benefit.[15]

4. Finally, the recent amendment to the revenue laws enacted in Section 116 of the Revenue Act of 1942 bears against petitioner. That section provides that upon the recovery of bad debts, prior taxes, or "delinquency amounts," that portion of the prior allowance which did not result in a tax reduction shall be excluded from gross income. Public Law 753, 77th Cong., 2d Sess.[16]

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[15] The Board in the case at bar also ascribed the entire failure to produce a tax saving solely to the excessive depreciation deduction, but the Commissioner cannot complain of the Board's action in this case because he stipulated that the excessive depreciation deductions did not offset taxable income (R. 25). The point is raised in other cases, however, and is relevant herein because it shows how thoroughly the Third Circuit Court erred. Its elaboration is also necessary to the point hereafter discussed in the text.

[16] SEC. 116. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) *Exclusion From Income.*—Section 22 (b) (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

The amendment deals with a problem analogous to that presented in the instant case. Prior to its adoption, the Third and Fourth Circuit Courts of Appeals had both held that such recoveries constituted income whether or not the prior deductions had resulted in a tax benefit. *Commissioner* v. *United States & Int. Sec. Corp.*, 130 F. 2d 894 (C. C. A. 3d); *Helvering* v. *State-Planters Bank & Trust Co.*, 130 F. 2d 44 (C. C. A. 4th). Moreover, in the *State-Planters* case, the court considered and rejected the argument that, in the

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"(12) *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

"(A) *Definition of Bad Debt.*—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

"(B) *Definition of Prior Tax.*—The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

"(C) *Definition of Delinquency Amount.*—The term 'delinquency amount' means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

"(D) *Definition of Recovery Exclusion.*—The term 'recovery exclusion,' with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner

absence of a tax benefit, the prior deductions had not been "allowed" within the meaning of the applicable regulations (Regulations 103, Sec. 19.23 (k)-1), and it relied on that decision in the instant case.

The statutory change is significant in two principal respects: *First,* the statute itself and the accompanying committee reports provide clear evidence that Congress does not regard the tax benefit theory as any part of the revenue laws in the absence of specific provision to that effect. *Secondly,* the judicial adoption of such a rule in the present situation would result in serious conflict between the application of that statute and such a judicial rule.

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with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph."

* * * * * * *

(b) *Effective Date of Amendments Under the Internal Revenue Code.*—The amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1938.

(c) *Under Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act, the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such revenue Act on the date of its enactment.

The new regulations have not yet been issued.

It is evident from a reading of the statute that it is framed on the theory that a deduction is "allowed" whether or not it has resulted in a tax reduction. The statute (clauses (A) and (B)) speaks specifically of deductions for bad debts and prior taxes "allowed" in a prior taxable year, although by hypothesis there was no tax benefit. Thus it uses the word "allowed" as we urge it should be used herein. Furthermore, the amendments assume that the recoveries would otherwise constitute taxable income. This is directly stated in the accompanying committee reports (S. Rep. 1631, 77th Cong., 2nd Sess., p. 79; H. Rep. 2333, 77th Cong., 2nd Sess., p. 69) and appears from the face of the statute. It is evident that Congress regarded the rule it was overturning as inexpedient rather than erroneous under previous law, and that in adopting the amendment Congress did not intend to reflect an over-all legislative policy to write a "tax benefit" test into the revenue laws generally. This conclusion is fortified by the fact that the amendment applies only in three carefully defined situations although obviously the question could arise in others.[17] The only reasonable inference to be drawn from the amendments is that Congress intended to change the law in those particulars and in no others.

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[17] Compare the instant situation, and those presented in *Harwick* v. *Commissioner*, 133 F. 2d 732 (C. C. A. 8th), certiorari applied for, No. 933, present term, and *Douglas* v. *Commissioner* (C. C. A. 8th), decided April 7, 1943.

The provisions of Section 116 (a) not only amended the Code but also, for the purposes of the Revenue Act of 1938 and prior revenue acts, were expressly made "effective as if they were a part of each such revenue Act on the date of its enactment." Section 116 (c), *supra*, note 16. The amendments, therefore, are part of the statute now under consideration by the court. It is a well-settled rule of statutory construction that where Congress has specifically dealt with a question in one section of a statute, that section will be regarded as exclusive. It will not be presumed that the matter was also regarded as covered in another section of general import. (Cf. *Baltimore Nat. Bank* v. *Tax Commission*, 297 U. S. 209, 215.)

With the question whether, as a matter of legislative tax policy, the "tax benefit" rule should be extended to this situation, we are not here concerned. So far, Congress has not extended it, and whether or not it ever will no one can say. The question basically is but another aspect of the broader problem of "lost" deductions, ordinarily in the forefront in connection with the adoption of provisions for loss carry-overs.

Adoption of petitioner's position herein would create a serious problem of conflict with the 1942 amendment, because in enacting that amendment Congress indicated that it wished the bad debt, tax, and "delinquency amount" deductions to be deemed to have been last deducted, so that they

will be deemed to have been of no tax benefit if the taxpayer could have refrained from deducting them without affecting his tax due for the year of deduction.[18] As we have pointed out,[19] in the absence of a legislative declaration no such rule can properly be adopted. If, therefore, the tax benefit rule be judicially applied to excessive depreciation deductions, how will the computation of the proportional benefit be made in the case of a taxpayer who has, for example, both a bad debt recovery to eliminate and a depreciation basis adjustment to make because of the tax benefit rule? And if the proportional benefit rule is not applied to excessive depreciation deductions, which deduction shall be deemed to have been taken last and hence to have been the source of no tax benefit, the bad debt, as to which Congress has specifically legislated, or the depreciation deduction, as to which it has not? We believe that had Congress been of the view that the tax benefit rule applied to excessive depreciation deductions, it would have given us the answer to these problems, for it could not have been blind to their existence. Its failure to do so is, we submit, further evidence that Congress was of the view that the tax-benefit rule is not applicable to excessive depreciation deductions.

[18] Senate Report 1631, 77th Cong., 2nd Sess., p. 80.
[19] *Supra*, pp. 25–27.

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted.

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MAY 1943.

FILE COPY

No. 766

In the Supreme Court of the United States

OCTOBER TERM, 1942

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG,
PETITIONER,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF

W. A. SUTHERLAND,
Amicus Curiae.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

Subject Index.

Table of Cases Cited.

In the Supreme Court of the United States

October Term, 1942

No. 766

Virginian Hotel Corporation of Lynchburg,
petitioner,

v.

Guy T. Helvering, Commissioner of Internal
Revenue.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

MOTION

Now comes the undersigned and moves for leave to file the annexed brief as amicus curiae. The undersigned is interested in the decision of this case because he is counsel for a taxpayer domiciled in the Fifth Circuit in an identical case now pending in the Board of Tax Appeals; and because he is counsel for another taxpayer domiciled in the Fourth Circuit, whose similar suit in the United States Court of Claims was recently dismissed on an administrative settlement by the Bu-

reau of Internal Revenue, and for whom suit must now be filed for other years if this petition for a writ of certiorari is not granted.

Letters from counsel for the Respondent and from the Solicitor General consenting to the filing of this brief have been filed with the clerk.

W. A. Sutherland,
First National Bank Building,
Atlanta, Georgia.

BRIEF AMICUS CURIAE

The Government, in its Brief in Opposition, admits the direct conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Third Circuit in *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. (2d) 155 (hereinafter called "the *Pittsburgh* case"), which case involved the same depreciation question here involved. The Government suggests, however, that the authority of the *Pittsburgh* case "has been considerably shaken" by the decision of the same court in the case of *Commissioner* v. *United States and International Securities Corp.,* 130 F. (2d) 894 (hereinafter called "the *United* case"), so that there is not now any conflict between the Third and Fourth Circuits on the issue here involved.

For the following, among other reasons, it would be utterly wrong to consider the decision of the Circuit Court of Appeals for the Third Circuit in the *United* case as indicating any withdrawal from its position in the *Pittsburgh* case:

1. Neither the *Pittsburgh* case, nor the subject of depreciation, is mentioned or suggested in the opinion of the Circuit Court of Appeals for the Third Circuit in the *United* case, which case in no way involved depreciation but involved solely the proper treatment of recoveries of bad debts previously charged off, where no tax benefit was derived from the charge-off.

2. The Circuit Court of Appeals for the Third Circuit in the *United* case, in considering its decision as to the effect of recoveries of debts previously charged off, did not even mention the word "allowed", on which words its decision in the *Pittsburgh* case largely turned.[1] The *United* opinion did not even refer to any

[1] The important portions of the *Pittsburgh* opinion are quoted in the Brief in Support, pp. 13-15.

portion of the law or regulations which contains the word "allowed". It may be that it should have considered the effect of Article 23(k)-1 of Regulations 94, which refers to bad debts, the charge-off of which has been "*allowed*";[2] but its opinion refers only to Article 42-1,[3] which contains no reference to the word "*allowed*".

3. The Government now urges that the questions involved in the *Pittsburgh* case and in the *United* case are substantially identical, so that "the two decisions cannot consistently stand together and the later case must be accepted as representing the present views of the court". But in its brief in the *United* case the Government squarely took the position that the decision in the *Pittsburgh* case had no bearing upon the issue before the court in the *United* case. It was there urged (*United* Brief, pp. 18-19):

> "The taxpayer also cites *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. (2d) 155 (C. C. A. 3rd), in support of its contention that the recovery in 1937 was not taxable, but that case involved a different question and a different statutory provision. There was no question there of a recovery after the deduction of a loss or a bad debt, but a question as to the proper basis for determining depreciation. The statute allows a taxpayer to subtract from the cost of its property depreciation to the extent allowed

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[2] Reg. 94, Art. 23(k)-1. "Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and *allowed* as a deduction for income tax purposes, must be included in gross income for the taxable year in which received." (Italics supplied.)

[3] Reg. 94, Art. 42-1. "Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See article 23(k)-1.)"

> but not less than the amount allowable. The taxpayer in that case had reported depreciation on several income tax returns in excess of amounts legally allowable. Thus, when the taxpayer asked to have an adjusted basis computed for later years, it argued that it should not be required to subtract the total amount of these depreciation deductions from its cost price as it had sustained net losses in the earlier years, and so the aggregate of such deductions did not represent depreciation which had been actually allowed. This Court agreed with that contention, holding that under the specific statutory provision involved there, the basis was to be computed by subtracting only depreciation which had been actually offset by taxable income in the year the deduction was taken. Other decisions cited by the taxpayer (Br. 13) also appear to turn on specific statutory provisions and do not involve a question of what constitutes gross income or present facts similar to these here."

In view of the above it is somewhat surprising to find the Government now contending that the two situations are inherently identical.

4. There is a fundamental distinction between the situations presented in the *Pittsburgh* case and the *United* case and the provisions of the law and regulations applicable thereto. In the *Pittsburgh* case the fact is that the depreciation deductions taken in prior years were in excess of those legally allowable; whereas in the *United* case the deduction of the debts in the earlier years was legal and proper.[4] The provision of the law

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[4] The court stated in its opinion in the *United* case (130 F. (2d) at p. 897):

> "It actually elected to take the losses in 1934 and 1935, and even if it did so as a result of a mistake of fact *there is ample evidence to support the Board's conclusion that the deductions could be taken properly in 1934 and 1935.*" (Italics supplied.)

as to depreciation (in effect only since 1932),[5] providing that basis shall be adjusted for the amount of depreciation *"allowed"*, even though in excess of the amount properly *"allowable"*, was enacted expressly to remedy a situation where admittedly excessive depreciation had been deducted without legal authority and had resulted in tax benefit, and the taxpayer was thereafter seeking to take advantage of an inconsistent position after the statute of limitations had run against the Government for the earlier years. There is no such contrast between *"allowed"* and *"allowable"* in the bad debt provisions of the regulations. See footnotes 2 and 3, *supra*. These provisions were not aimed primarily, if at all, to cover the situation where items were improperly deducted without legal authority in a prior year and the taxpayer is later seeking to ignore the deduction to the unfair disadvantage of the Government. On the contrary, the provisions with reference to recovery of bad debts were aimed primarily to cover the normal situation where the debts constituted proper deductions in the years of charge-off, but are later recovered. These bad debt regulations have been unchanged since 1921 (Reg. 62, Arts. 52 and 151),[6] at which time the necessity of protecting the Government against inconsistent positions on the part of taxpayers had not yet impressed itself upon any one in authority.

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[5] I. R. C., 113 (b)(1)(B) provides that the basis of property shall be adjusted

> "In respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent *allowed* (but not less than the amount *allowable*) under this chapter or prior income tax laws." (Italics supplied.)

[6] There is no reason to discuss in this brief what, if any, change in these regulations was effected by section 116 of the Revenue Act of 1942. That section is fully discussed in the main briefs.

CONCLUSION

There is a direct conflict between the views of the Third and Fourth Circuits on the question involved in the *Pittsburgh* case and the case at bar; the question involved is one of large importance; and it seems clear that a writ of certiorari should be granted.

Respectfully submitted,

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Amicus Curiae.

In the

Supreme Court of the United States

October Term, 1942

No. 766

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG,
Petitioner,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit

BRIEF ON BEHALF OF PITTSBURGH BREWING COMPANY AS *AMICUS CURIAE*

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Pittsburgh Brewing Company,
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INDEX

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BRIEF ON BEHALF OF PITTSBURGH BREWING COMPANY AS *AMICUS CURIAE*

Preliminary Statement

This brief is filed by the Pittsburgh Brewing Company as *amicus curiae* with the consent of both parties to the proceedings in accordance with the rules of the Court.

The judgment of the Circuit Court of Appeals for the Fourth Circuit in *Guy T. Helvering, Commissioner of Internal Revenue v. Virginian Hotel Corporation of Lynchburg*, 132 Fed. (2d) 346, presents a conflict with that rendered by the Circuit Court of Appeals for the Third Circuit in *Pittsburgh Brewing Company v. Commissioner of Internal Revenue*, (1939) 107 Fed. (2d) 155. This Court has granted the application of the petitioner herein for a writ of certiorari. [illegible] L. ed. [illegible].

Question Presented

Is a taxpayer estopped to correct an erroneous deduction for depreciation reported in a loss year where he has not profited by his mistake and the Treasury has suffered no loss thereby? In other words, must a taxpayer's basis for determining gain or loss on the sale of depreciable assets and for computing annual depreciation allowances be reduced by the erroneous excess of depreciation deductions reported in loss years.

Statute Involved

The statute involved is the Revenue Act of 1938 (52 Stat. 447), Section 23(l) and 23(n), 113(b)(1)(B) and 114(a). These sections provide as follows:

> "Sec. 23. Deductions From Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> * * * *
>
> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> * * * *
>
> (n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.
>
> * * * *
>
> Sec. 113. Adjusted Basis for Determining Gain or Loss.
>
> * * * *
>
> (b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

Statement

The case arose in the U. S. Board of Tax Appeals (now The Tax Court of the United States) and was tried on a stipulation of facts. In substance, the agreed facts presented the following situation which frames the disputed issue of the case:

The petitioner operated a hotel and, in connection therewith, owned various depreciable assets. From June 1, 1927 to December 31, 1938 the petitioner and its predecessor in interest had taken depreciation thereon at 15% a year on carpets and 10% a year on all other equipment. After examining petitioner's return for the year 1938, respondent determined that these depreciation rates were clearly excessive, that the proper rates were 8% on carpets and 5% on all other equipment. The Commissioner conceded that the erroneous rates used by petitioner (approximately 100% greater than that properly allowable on the carpets and 100% greater than the proper rate on the other equipment) were excessive on the known facts in all prior years as well. However, although petitioner had had loss years for 1931 to 1936, inclusive, in which the mistake did not profit the petitioner or prejudice the respondent in view of the fact that petitioner had no tax to pay in any event, respondent insisted that the mistake was beyond correction. Consequently, he determined that the basis of petitioner's as-

sets for the computation of depreciation must be reduced not only by the amount of the properly allowable depreciation for the loss years (1931-1936, inc.) but also the erroneous excess which was mistakenly reported in the said years.

Respondent took the position that where an amount of depreciation is reported on a return, the taxpayer's basis is forever reduced thereby even if the amount so reported is an obvious error—a palpable mistake in the rate, an error in the computation of basis or even a mathematical error in computing the item to be entered on the return—notwithstanding that the taxpayer is not estopped to make the correction. His theory was that the erroneous deduction was "allowed" to the taxpayer by the mere filing of the return containing the item and respondent's inaction with respect thereto.

In the resulting computation based upon respondent's theory, petitioner's basis, adjusted by all deductions reported in prior years, is then spread ratably over the correct remaining useful life of the assets.

The Board of Tax Appeals, following the decision rendered by the Third Circuit in the Pittsburgh Brewing Company case, sustained the taxpayer's contention that basis should not be reduced by the erroneous excess of depreciation reported in the loss years where on the then known facts the amounts reported were excessive (The unreported memorandum opinion of the Board is printed in the record herein at p. 34).

Summary of Argument

The depreciation provisions of our tax laws should be construed in accordance with the expressed opinions of the Congress at the time of the enactment. The language of the particular section under review should be inter-

preted in the accepted sense of its terms and in the light of the evil which it was designed to correct. The Committees of Congress which framed the section stated that the purpose of the amendment to Section 113(b)(1)(B) was to preclude the possibility of taxpayers' obtaining double deductions through depreciation allowances, although the law was then admittedly adequate to prevent such a possibility. The scope of the section should, therefore, not be extended so as to prevent the rectification of errors reported in loss years where, on accepted principles of law, no estoppel lies.

ARGUMENT

I

Under settled principles of law a taxpayer who reports an erroneous deduction in his return in a loss year is not barred from correcting his mistake where he has not profited thereby and the Treasury has suffered no loss.

Stripped of all collateral issues, this case presents a comparatively simple tax problem. Stated briefly, the issue is whether a taxpayer is irrevocably charged with erroneous depreciation deductions reported on his returns where he has not profited by his mistakes and where the Commissioner has suffered no loss therefrom. In other words, must a taxpayer's base be reduced by the excessive amounts of depreciation so reported both for the purpose of computing annual depreciation deductions and for determining gain or loss on sale of depreciable assets.

Much has been said in the opinion of the Court below and in other decisions recently rendered concerning the application of the so-called "tax benefit theory" to the

issue here involved.[1] We respectfully submit that the question presented on this appeal is not bottomed on the subject of tax benefit at all. On the contrary, we are here concerned with the simple question whether the principles of law applicable to the adjustment in tax returns of errors made in the reporting of expenses and other deductions shall not be available in the case of errors made in the reporting of depreciation deductions.

In the instant case it was stipulated before the Board of Tax Appeals that during all of the years in question the petitioner had employed erroneous rates of depreciation. On the known facts in the said years the rates used were admittedly excessive. Since the petitioner did not profit by its mistakes is it estopped to adjust its base by eliminating the excessive credits to its depreciation reserve?

In the last analysis the problem projected by the language "allowed (but not less than amount allowable)", contained in Section 113(b)(1)(B) is one of avoidance of double deductions.[2] The history of the legislative amend-

[1] *Helvering* v. *Virginian Hotel Corporation of Lynchburg* (C. C. A. 4), 132 Fed. (2d) 909.

Don Lee, Inc. v. *U. S.* (D. C. Cal.) 42 F. Supp. 884.

Com'r. of Internal Revenue v. *Kennedy Laundry Company* (C. C. A. 7), decided February 15, 1943.

[2] *Mertens "Law of Federal Income Taxation"*, Vol. 3, pp. 637-8 says in this connection:

> "The question has arisen whether the basis under the 1932 and subsequent acts must be reduced not only by the depreciation allowable, but also by the excess deducted on the return where the taxpayer by reason of other deductions derives no tax benefit in the form of reduced net income by reason of the excess deducted, in other words, where the net income is zero or less regardless of the excess deducted. The decision in a recent case was that the basis in such a situation was not to be further reduced over and above the depreciation allowable, by the excess claimed on the return. This seems sound, since the purpose of compelling the taxpayer to reduce his basis by the amount allowed is to prevent the taxpayer from enjoying a double deduction as clearly appears from the Congressional Committee Reports."

ments to the depreciation sections of our revenue laws furnishes ample evidence of the Congress' efforts to plug the loopholes in that branch of the law. We shall not here review this legislative history for the reason that adequate treatment of the subject has been given thereto in the petitioner's brief. That analysis clearly demonstrates that in the successive changes of the phraseology pertaining to depreciation adjustments the Congress was struggling to achieve a provision under which taxpayers would be afforded an opportunity to recover their capital investments and the Treasury Department would be entitled to recover a just tax. The change from the words "previously allowed" as contained in the Revenue Act of 1924[3] to "allowable" as contained in the Revenue Act of 1926[4] and finally to the words "allowed (but not less than the amount allowable)", as contained in the Revenue Act of 1932,[5] was the result of the studied attempt by the Congress to eliminate the difficulties which experience in the administration of this subdivision of our tax laws had produced.

The report of the Senate Finance Committee (Sen. Rep. 665, p. 29, 72 Cong. 1st Sess.), issued in connection with

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[3] Sec. 202(b), Revenue Act of 1924 (43 Stat. 253).

[4] Sec. 202(b), Revenue Act of 1926 (44 Stat. 9).

[5] Sec. 113(b)(1)(B) Revenue Act of 1932 (47 Stat. 169).
This section reads as follows:

"Sec. 113. Adjusted Basis for Determining Gain or Loss.

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

the Revenue Act of 1932, is specific in its statement of the reasons for the amendment to Section 113(b)(1)(B).[6] The Committee acknowledged that the section as amended was merely a codification of existing law. When it said: "While the Committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility", it made it quite clear that it was not changing or adding anything to the law. It was merely inserting phraseology, consistent with the law as it then understood it to be, which would minimize or eliminate entirely the annoyances and inconveniences resulting from attempts by taxpayers to circumvent the law.

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[6] *The Senate Finance Committee Report* (Sen. Rep. 665, p. 29, 72nd Cong., 1st Sess.) contains the following statement:

"In subparagraph (B), (of Sec. 113(b)(1)), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of 'by the amount * * * allowable' as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer and the Treasury should not be penalized for having approved the taxpayer's deductions. While the Committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.

"Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

It is difficult to read the report of the Senate Finance Committee, in the light of the legislative history of Section 113(b)(1)(B), and reach any other conclusion but that in the enactment of this section the Congress was aiming to prevent double deductions. Congress was not laying down a new set of legal principles which would apply differently to depreciation deductions than to deductions for any ordinary business expenses. Under the Revenue Act of 1926, which provided that basis be diminished by depreciation deductions which have been "allowable", a taxpayer who deducted a greater amount of depreciation than was properly allowable would nevertheless be bound by the excess depreciation if such excess had off-set taxable income. The doctrine of estoppel would serve to prevent him from recovering that part of his capital investment again in a later year. Since the regulations and the authorities had for many years provided that depreciation allowances were granted as a means of returning one's capital investment tax-free, any attempt by a taxpayer to take a double deduction by eliminating an erroneous depreciation deduction which had off-set taxable income in a prior year would be thwarted by settled principles of law.[7] While the Senate Finance Committee recognized this fact, it nevertheless preferred to have the Revenue Act "specifically preclude any such possibility."

Nothing in the legislative history of depreciation deductions indicates any int ntion on the part of the Congress to deny to taxpayers the right to rectify mistakes in the determination or computation of depreciation. In approaching this phase of the problem, however, we must be certain to distinguish between errors based upon the known facts in the prior loss years when the erroneous rates were used and the correction of rates resulting from

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[7] *U. S.* v. *Ludey*, 274 U. S. 295.
Cameron v. *Commissioner of Internal Revenue* (C. C. A. 3) 56 Fed. (2d) 1021.

new estimates gained from experience with the property. The regulations have consistently required that allowable depreciation be determined "on the basis of facts reasonably known to exist at the end of such year or period."[8] Where, however, on the known facts the amount of depreciation reported in a given year is erroneous, nothing contained in the regulations have prevented the rectification of the error to a taxpayer's basis in the same way that any error in the reporting of a deduction may be corrected. In such event the burden of proof has been on the taxpayer to show that the rates employed or the computation made were, on the then known facts, erroneous and that he did not profit by his mistakes.

In the instant case respondent stipulated that in the prior loss years the rates used by the petitioner were excessive. The parties therefore recognized and agreed that the excess amount of depreciation reported in those years was a mistake. If the petitioner had profited by its mistake or if the respondent in reliance upon the deduction had acted to his prejudice or loss, the petitioner would be estopped to rectify the error. Since, however, it is conceded that such was not the case (in fact respondent has never pleaded an estoppel) there is no rule of law which binds the petitioner to the erroneous deductions reported and prevents the proper adjustment to its base for the purpose of computing the correct amount of current allowable depreciation.

The principle involved in this case is identical with that involved in the case of *Pittsburgh Brewing Company* v.

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[8] Reg. 65, Art. 165.
Reg. 69, Art. 165.
Reg. 77, Art. 205.
Reg. 86, Art. 23 (L)-5.
Reg. 94, Art. 23 (L)-5.
Reg. 101, Art. 23 (L)-5.

Commissioner, 107 F. (2d), 155, although the error in the loss years in that case resulted from a gross error in the basis used and not in the rate. Depreciation is a product of base and rate and an error on either side of the equation has the same practical effect.[9]

It is respectfully submitted that the principle enunciated in the Pittsburgh Brewing case is sound and is applicable to the case at bar. Where none of the elements which customarily combine to spell out an estoppel is present in the case there is no reason for denying to a taxpayer the right to correct an error reported in a prior return. Depreciation charges are not expenses incurred in the ordinary sense, as rent or salaries, but are bookkeeping computations. An error in such a computation which is not prejudicial to the Commissioner, whether it be the result of a mistake in the base or in the rate, should not be deemed a permanent irrevocable charge which is beyond correction. If respondent's interpretation of the law is correct, a taxpayer would be bound by an erroneous depreciation deduction resulting from a mistake in arithmetical computation since, as respondent views the law, by the mere filing of the return the erroneous deduction is deemed "allowed".

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[9] When the error is in the base rather than in the rate, as in the Pittsburgh case, the analogy between errors and depreciation deducted and error in valuations used in tax returns is more clearly apparent. No other error in valuation binds a taxpayer in subsequent years, except upon the basis of estoppel. Clearly the general law prior to the enactment of Section 113(b)(1)(B) would not have bound a taxpayer who used a wrong base for depreciation except upon a similar principle, and, as clearly pointed out above, that statute did not mean to bar a taxpayer, except upon some similar principle similar to estoppel.

II

The practical features of the depreciation problem favor the interpretation of Section 113(b)(1)(B) which the Third Circuit employed in the Pittsburgh Brewing case.

1. No Administrative Difficulties Arise by Reason of this Interpretation.

All deductions of whatsoever nature which are reported by a taxpayer, rest on facts which, in the first instance, are within the taxpayer's own knowledge. This is true, for example, respecting deductions involving proof of cost, compensation to officers, bad debts and indeed any ordinary business expense. It does not follow that because the taxpayer prepares his own return, based upon his own knowledge of the facts, that the tendency is to misrepresent or overstate his deductions. Respondent's argument that the position advocated by the petitioner would create an incentive to file false returns and involve the Bureau of Internal Revenue in grave administrative difficulties is largely ephemeral. This is apparent when one considers the administrative practice which maintains in the examination and audit of returns which are likely to involve depreciation problems.

In the administrative practice of the Bureau of Internal Revenue, all individual income tax returns showing gross income of $25,000 or more and all corporate returns showing gross income of $75,000 or more are, except in loss years, sent into the field for examination after the preliminary office audit.[10] Moreover, depreciation is a subject of review by the Engineering & Valuation Division of the Bureau which passes upon the problems raised under T. D.

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[10] *Paul and Mertens, "Law of Federal Income Taxation"*, Vol. 5, Sec. 42.34. *Prentice-Hall, Federal Tax Service*, Par. 18,101.

4422, containing the regulation pertaining to the method and procedure of reporting depreciation deductions.[11]

It is safe to say, therefore, that there are comparatively few income tax returns showing profits, where depreciation deductions are involved, which are not subjected to a field examination by the Bureau. The first profit return of a taxpayer in which a new rate of depreciation is used will invariably be examined by the Bureau. Since the decentralization of the Bureau in 1937, with the resulting establishment in each local district of a separate Valuation Section, the organization for the examination of such returns and the study of depreciation questions has been so thorough that, as a practical problem, the dangers envisioned by the respondent are insignificant.

2. The Necessity for Recomputing Depreciation Frequently Arises and Creates no Difficult Administrative Problem.

Situations are numerous in which it is essential, for the computation of a taxpayer's correct liability, to reexamine the items contained in prior returns. For example, in the Revenue Act of 1942 (Public Law 753, 77th Cong., 2d Sess.), it is provided in Section 116 that recoveries of income with respect to bad debts, prior taxes and delinquency amounts which were charged off in prior years where tax savings were thereby accomplished do not constitute taxable income.[12] Also, in the computation of gain or loss on the sale of depreciable assets, the practice is to disregard all prior deductions and to recompute the correct allowable depreciation for the preceding years. In

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[11] *Paul & Mertens*, Sect. 42.30.

[12] Under section 23(s) and 122(a) and (b) of the Revenue Act of 1942 it may be necessary for the Bureau to re-examine returns for five years in determining the net operating loss deduction resulting from the carry-back and carry-over provisions.

other words, if a taxpayer has taken less depreciation than the amount which was properly allowable to him his base is reduced in such recomputation by the full allowable depreciation. This procedure should be borne in mind when it is argued that the petitioner's contention would result in grave administrative difficulties. It is true also that wherever experience with depreciable assets proves that the rate which was used was either excessive or inadequate, it is necessary to review all prior returns to determine the residual undepreciated cost for the purpose of projecting the same forward over the remaining redetermined useful life of the assets. While such procedure involves detail, it has never proved prohibitive.

3. The Correction of Mistakes in Depreciation Involve no Administrative Problem and Should not be Prohibitive.

As this discussion has illustrated, computation of tax liabilities and the recomputation of depreciation deductions, as well as of the adjusted base of depreciable assets are a commonplace. If, therefore, a taxpayer is able to show that a bona fide mistake was made in the computation of a depreciation deduction reported on his return and that he did not profit by his mistake, the correction thereof by adjustment to his base creates no particular problem for the Bureau.

We are of course not addressing ourselves to the problem of fraudulent returns in which taxpayers with deliberate intent overstate their allowable deductions. Mistakes, however, frequently occur in the determination of basis or of the rate of depreciation or of a mere mathematical computation. If the taxpayer has not been unjustly enriched thereby or is not estopped to make the correction, there is no plausible reason why the adjustment may not be accomplished under normal administrative procedure. In passing, it should be noted that no claim has been made that the computation of the depreciation deduction or the de-

termination of basis or rate upon which such computation is made constitutes an election which, when once made, is irrevocable. Indeed, nothing contained in Section 113(b)-(1)(B) or the regulations or the Committee reports would indicate that the amount of depreciation reported represents an election.

III

The analogy drawn by the Fourth Circuit to bad debt recoveries is unsound and its decision should be reversed.

The opinion of the Court below is predicated upon its own prior holding to the effect that recoveries of income on bad debts previously charged off in loss years are taxable. It is then argued analogously by the Court that the question of tax-benefit is alike in depreciation as well as bad debt cases and that consequently a taxpayer's basis must be reduced by all depreciation deductions which have been reported, irrespective of tax-benefit.

This argument, we submit, is unsound and is founded upon a false premise. Depreciation deductions are not wedded to the theory of tax-benefit. Deductions which are properly allowable reduce a taxpayer's base whether such deductions off-set taxable income or not. In drawing an analogy to bad debt recovery cases the lower Court overlooked the very important fact that bad debt deductions are "allowable" deductions and that as such it is wholly immaterial that they have not off-set taxable income. Where a debt is ascertained to be worthless, the investment therein is lost, and therefore it may very well be, as the lower Court has previously held, that the recovery of proceeds therefrom in a later year constitutes taxable income notwithstanding that no tax benefit was realized in the year of deduction. The Treasury has itself had great difficulty

making up its mind on this point.[13] But the analogy is unsound for, as we have pointed out, the case at bar is not concerned with properly allowable deductions. If in *Helvering v. State-Planters Bank & Trust Co.*, 130 Fed. (2d) 44 the taxpayer had taken an *erroneous bad debt deduction* in a loss year would the Fourth Circuit have held that the recovery of the debt in a subsequent year constituted taxable income? In that situation a parallel to the instant case might have existed. We are here dealing with an erroneous deduction and not, as in the *State-Planters* case, with a properly deducted bad debt in the year of ascertainment.

Allowable depreciation, as the petitioner concedes in the case at bar and as was conceded in the *Pittsburgh Brewing* case, must be deducted from basis even though it does not off-set taxable income. But where a mistake has been made in the computation of depreciation and the taxpayer has not profited by his mistake, neither the statute nor any known legal theory requires that the error be perpetuated and prevents its due correction.

In the Revenue Act of 1942 the Congress gave recognition to the fact that in the bad debt cases it was inequitable to charge a taxpayer with the receipt of taxable income where the deduction of the bad debt in a prior year did not off-set taxable income and even though the deduction in the prior year was proper or "allowable". In view of the Treasury's own vacillation on this subject and the confusion which it had created, the enactment seems to have had the purpose of setting that troublesome problem at rest on equitable principles.

On the subject of erroneous excess depreciation, however, existing legal principles were adequate for the purpose of reaching a just result and the courts had uni-

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[13] G. C. M. 18525, C. B. 1937-1, p. 80.
G. C. M. 20854, C. B. 1939-1, p. 102.
G. C. M. 22163, C. B. 1940-2, p. 76.

formly held prior to the enacting of the Revenue Act of 1942 that where on the known facts an error had been made, that error might be corrected if the taxpayer was not estopped to do so. Since the Congress saw fit to provide that even where an *allowable* bad debt deduction had been taken no taxable income is realized in the year of recovery unless a tax benefit had been obtained in the loss year, it is inconceivable that, in the face of existing judicial authority, it intended to discriminate against taxpayers who had made a mistake in loss years and deny to them the right, which is available respecting other ordinary deductions, to rectify the error.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 766.—OCTOBER TERM, 1942.

Virginian Hotel Corporation of Lynchburg, Petitioner, *vs.* Guy T. Helvering, Commissioner of Internal Revenue.	}	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[June 7, 1943.]

Mr. Justice DOUGLAS delivered the opinion of the Court.

The facts of this case are stipulated. Petitioner operates an hotel. From 1927 through 1937 petitioner (or its predecessor) reported in its income tax returns depreciation on certain of its assets on a straight line basis.[1] No objection was taken by the Commissioner or his agents to the amounts claimed and deducted. In 1938 petitioner claimed a deduction for depreciation at the same rates. The Commissioner determined that the useful life of the equipment was longer than petitioner claimed and that therefore lower depreciation rates should be used.[2] Accordingly a deficiency was computed. The depreciation theretofore claimed as deductions was subtracted from the cost of the property. The remainder was taken as the new basis for computing depreciation. A lesser deduction for depreciation accordingly was allowed.[3] There had been a net gain for some of the years in question. For the years 1931 to 1936 inclusive there was a net loss and, says the stipulation, "the entire amount of depreciation deducted on the income tax returns for those years did not serve to reduce the taxable income." Petitioner does not challenge the new rates. It contends that the amount of depreciation claimed for the years 1931 to 1936 inclusive in excess of the amount properly allowable should not be subtracted

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1 15% on carpets and 10% on all other equipment. At those rates the properties would have been fully depreciated in 6⅔ and 10 years respectively.

2 8% on carpets and 5% on the other equipment, the estimated life being 12½ years and 20 years respectively.

3 $1,295.47 for 1938 as compared with $4,341.97 which was claimed. The difference between the depreciation claimed in the loss years and the depreciation properly allowable in such years is $31,400.25.

from the depreciation basis, since it did not serve to reduce taxable income in those years. The Tax Court in reliance on an earlier ruling[4] held for the petitioner. The Circuit Court of Appeals reversed. 132 F. 2d 909. The case is here on a petition for a writ of certiorari which we granted because of a conflict between the decision below and *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155, decided by the Circuit Court of Appeals for the Third Circuit.

A reasonable allowance for depreciation is one of several items which Congress has declared shall be "allowed" as a deduction in computing net income. Int. Rev. Code § 23(1). The basis upon which depreciation is to be "allowed" is the cost of the property with proper adjustments for depreciation "to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws."[5] That provision makes plain that the depreciation basis is reduced by the amount "allowable" each year whether or not it is claimed. *Fidelity-Philadelphia Trust Co.* v. *Commissioner,* 47 F. 2d 36. Moreover the basis must be reduced by that amount even though no tax benefit results from the use of depreciation as a deduction. Wear and tear do not wait on net income. Nor can depreciation be accumulated and held for use in that year in which it will bring the taxpayer the most tax benefit. Congress has elected to make the year the unit of taxation. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. Thus the amount "allowable" must be taken each year. *United States* v. *Ludey,* 274 U. S. 295, 304.

But it is said that "allowed" unlike "allowable" connotes the receipt of a tax benefit. The argument is that though depreciation in excess of an "allowable" amount is claimed by the taxpayer and not disallowed by the Commissioner, it is nevertheless not "allowed" if the deductions other than depreciation are sufficient to produce a loss for the year in question. "Allowed" in this setting plainly has the effect of requiring a reduction of the depreciation basis by an amount which is in excess of depre-

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4 Kennedy Laundry Co. *v.* Commissioner, 46 B. T. A. 70, which followed Pittsburgh Brewing Co. *v.* Commissioner, 107 F. 2d 155. Prior to the Kennedy Laundry Co. case and prior to the time when Pittsburgh Brewing Co. *v.* Commissioner, 37 B. T. A. 439, was overruled, the Tax Court took a contrary view. Its decision in the Kennedy Laundry Co. case was reversed by the Circuit Court of Appeals. 133 F. 2d 660.

5 Sec. 113(b)(1)(B) which is made applicable by reason of § 23(n), § 114, and § 113(a).

ciation properly deductible. We do not agree, however, with the contention that such a reduction must be made only to the extent that the deduction for depreciation has resulted in a tax benefit. The requirement that the basis should be adjusted for depreciation "to the extent allowed (but not less than the amount allowable)" first appeared in the Revenue Act of 1932. 47 Stat. 169, 201. Prior to that time the adjustment required was for the amount of depreciation "allowable".[6] The purpose of the amendment in 1932 was to make sure that taxpayers who had made excessive deductions in one year could not reduce the depreciation basis by the lesser amount of depreciation which was "allowable". If they could, then the government might be barred from collecting additional taxes which would have been payable had the lower rate been used originally.[7] But we find no suggestion that "allowed", as distinguished from "allowable", depreciation is confined to those deductions which result in tax benefits. "Allowed" connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed" since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are "allowed". And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be "allowed" and others not "allowed".[8] It would take clear and compelling indications for

6 For a summary of the legislative history, see 40 Col. L. Rev. 540.

7 S. Rep. No. 665, 72d Cong., 1st Sess., p. 29: "The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility."

8 As we have noted, the stipulation of facts states that "the entire amount of depreciation deducted on the income tax returns" for the years in question "did not serve to reduce the taxable income." That has been taken to mean

us to conclude that "allowed" as used in § 113(b)(1)(B) means something different than it does in the general setting of the revenue acts. See *Helvering* v. *State-Planters Bank & Trust Co.*, 130 F. 2d 44.

Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retirement. *United States* v. *Ludey, supra; Detroit Edison Co.* v. *Commissioner*, 318 U. S. —. The rule which has been fashioned by the court below deprives the taxpayer of no portion of that deduction. Under that rule taxpayers often will not recover their investment tax-free. But Congress has made no such guarantee. Nor has Congress indicated that a taxpayer who has obtained no tax advantage from a depreciation deduction should be allowed to take it a second time. The policy which does not permit the second deduction in case of "allowable" depreciation (*Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318) is equally cogent as respects depreciation which is "allowed".

Affirmed.

that no part of the depreciation deduction resulted in tax benefits. We do not stop to inquire how that could be true when the depreciation deducted on each return from 1931 through 1936 was larger than the net loss for each of those years. If the stipulation were not accepted, one other problem would be presented. That is the theory that when there is a loss, depreciation may be singled out as not offsetting gross income even though it is only one of several deductions which is claimed. See Kennedy Laundry Co. *v.* Commissioner, 46 B. T. A. 70, 75, Judge Disney dissenting. In view of the stipulation we do not reach that question. Cf. Butler Bros. *v.* McColgan, 315 U. S. 501, 508-509.

Mr. Chief Justice Stone, dissenting.

It is true that the 1938 Revenue Act does not speak of a "tax benefit" to the taxpayer. Section 23 speaks only of deductions from gross income which "shall be allowed" in computing net income, among which it includes, § 23(l), 'a reasonable allowance for the exhaustion, wear and tear of property used in trade or business". And by § 113(b)(1)(B) the basis for depreciation of property is its cost adjusted by depreciation "to the extent allowed (but not less than the amount allowable)". It is equally

true and obvious, and of some importance to the correct interpretation of the statute, that any depreciation in excess of the reasonable allowance authorized can, under the statute, result in no tax advantage to the taxpayer and in no tax prejudice to the Government, unless the excess has in fact been deducted from the taxpayer's gross income.

I can find no warrant in the purpose or the words of the statute, or in the principles of accounting, for our saying that the taxpayer is required to reduce his depreciation base by any amount in excess of the depreciation "allowable", which excess he never has in fact deducted from gross income. Whatever else the statutory reference to depreciation "allowed" may mean, it obviously cannot and ought not to be construed to mean that a deduction for depreciation which has never in fact been subtracted from gross income is a deduction "allowed".

And there is no reason why such should be deemed to be its meaning. The only function of depreciation in the income tax laws is the establishment of an amount, which may be deducted annually from gross income, sufficient in the aggregate to restore a wasting capital asset at the end of its estimated life. The scheme of the 1938 Revenue Act is to prescribe the permissible deductions for depreciation, and to preclude the taxpayer from gaining any unwarranted advantage by the amount and distribution of those deductions. The Act accomplishes the latter by compelling the taxpayer to reduce his depreciation base by the amount of the allowable annual depreciation, whether deducted from gross income or not, and by such further amount as he has in fact deducted from gross income. No reason is suggested why the taxpayer's tax for future years should be increased by reducing his depreciation base by any amount in excess of the depreciation "allowable", unless the excess has at some time and in some manner been deducted from gross income. So inequitable a result cannot rightly be achieved by saying that a "deduction" for depreciation which never has been deducted from gross income has nevertheless been "allowed".

What I have said does not imply that a taxpayer, who has deducted excessive depreciation from his gross income in any year, is not subject to a deficiency assessment as the statutes and regulations prescribe; or that excessive deductions for depreciation taken from gross income—or allowable depreciation, whether

so deducted or not—may not properly be used to reduce the taxpayer's depreciation base. The statute so provides. But I do assert that, under the system of taxation which we have established, the overstatement of the taxpayer's depreciation base on which the Government insists is not to be justified because the taxpayer may in some other year have deducted from gross income excessive depreciation which has already been subtracted from his depreciation base. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365. The statute neither compels nor permits so incongruous a result. The judgment should be reversed.

Mr. Justice ROBERTS, Mr. Justice MURPHY and Mr. Justice JACKSON join in this dissent.

Mr. Justice JACKSON, dissenting.

The first and fundamental step in determining accrued depreciation is to estimate the probable useful life of the property to be depreciated. This depends upon judgment and is not capable of exact determination. When it is found, and after making allowance for probable salvage value at the time of retirement, it is a mere matter of mathematics to compute under the straight-line method the rate of annual accrual.

This rate when applied to the cost of the depreciable property fixes two things: (1) The amount of the depreciation accrual to deduct from gross, before determining net, income. For this purpose a high rate works in favor of the taxpayer for any given year. (2) It also determines the amount by which the cost base must be reduced for application of depreciation rates the following year. In this aspect a high depreciation rate works in favor of the Government.

The Virginian Hotel Corporation misconceived, as the Commissioner thinks, the probable life of its depreciable property. Attributing to it a longer life span, he corrected that judgment. To apply that correction consistently would lower the rate and consequent deduction on account of depreciation and cause a smaller subtraction from the valuation base, leaving a larger base to which the smaller rate would be applied.

The Commissioner proposed to correct taxpayer's returns by considering only the year in question. He eliminated the error

as far as it affected the rate and thus reduced the depreciation accrual and increased the tax. But he retained the base as reduced by the taxpayer's accumulated errors, refusing to readjust the base consistently with the corrected depreciation rates.

To the extent that the taxpayer had obtained advantage from the use of the higher depreciation rate, I would think it quite justifiable to refuse to make a correction. The Government, however, stipulates as to the years in question that "the entire amount of the depreciation deducted on the income tax returns for those years did not serve to reduce the taxable income." We should not disregard a deliberately made stipulation, even if, on our limited knowledge of its background, we are in doubt as to why it was made. The question comes simply to this: Whether the Commissioner, upon determining whether taxpayer has in good faith erred, may use a correction in so far as it helps the Government and adhere to the mistake in so far as it injures the taxpayer. I think that no straining should be done to find a construction of the statutes that will support the result.

I am the less inclined to lay down a rule that will permit the Government to make inconsistent corrections in the matter of depreciation because consistency in the matter of depreciation is one of the few important principles of its application. There has been no more futile tax litigation than that over depreciation rates. In an era of rising taxes the faster a taxpayer depleted his base for depreciation the more the Government realized in revenue from him. If this present taxpayer had been permitted to continue its high depreciation rates, it would have come into the present era of exceedingly high taxes with its depreciation base correspondingly exhausted. What is important for the protection of the revenues is that accrual for depreciation be applied only to property that is properly depreciable, that it be stopped when the property is fully depreciated, and that the rate be consistently applied so that the taxpayer cannot choose to take only a little depreciation when he has a little income and a lot of depreciation when he has a large income. If these conditions are observed, litigation about the rate serves chiefly to vindicate theories rather than to protect the revenues.

If the Government desires to make revisions of theoretical rates, there is no reason why it should not observe the rule of consistency that is one of the cardinal rules to impose on the taxpayer. Hence, I join in the dissenting opinion of the CHIEF JUSTICE.